THE TREATMENT OF SECURITY HOLDERS UNDER THE ABSOLUTE PRIORITY RULE IN CHAPTER X REORGANIZATIONS

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KEY TO ABBREVIATIONS

S.E.C. . . . . .Securities and Exchange Commission

I.C.C. . . . . .Interstate Commerce Commission

P.U.H.C. . . . . .Public Utility Holding Company

R.F.C. . . . . .Reconstruction Finance Corporation

CHAPTER I

INTRODUCTION

Purpose of the Dissertation

The purpose of this dissertation is to determine whether inequities result from the application of the absolute priority rule in the reorganization of industrial corporations under Chapter X of the National Bankruptcy Act (1:52;883-897)(1:54;709-710)(1:60;331-332). In the event inequitable treatment is found, possible means of minimizing such treatment through the financial plan of reorganization will be examined.

Background Information

Since 1938, reorganization of publicly held industrial corporations have been conducted almost entirely under Chapter X of the National Bankruptcy Act. In reorganizations under this Chapter, the Securities and Exchange Commission, under certain circumstances has a duty, and under other circumstances has a discretionary power, to serve as an adviser to the United States District Courts. In many cases, the proposed plans of reorganization are referred to the Securities and Exchange Commission for preparation of advisory reports. The courts may accept, reject, or modify the position of the Securities and Exchange Commission.

The legal postulates for financial plans of reorganization are

to be found principally in Case v. Los Angeles Lumber Products Company, Ltd. (2, p. 106), and in Consolidated Rock Products Company v. du Bois (3, p. 675). These cases firmly established the absolute priority rule as the law of the land. This rule required that creditors be recognized in the order of their priorities and be compensated in accordance with their contractual rights, as if in corporate liquidation, with an award of cash and/or new securities which will maintain their legal priorities, insofar as possible. Stockholders may participate in the reorganized corporation only to the extent an equity remains for them.

Theoretical Considerations

In order to apply the absolute priority rule, a valuation of the corporation must be made at the time of reorganization. The questions raised are:

1. What method of valuation is required by the law?
2. What method of valuation is used by the Securities and Exchange Commission?
3. Is there any evidence of inequity as a result of the valuation?
4. What are the proper tests of equitable treatment as a result of the valuation?
5. Is the court or the Securities and Exchange Commission under any obligation to allow for a difference in valuation at the time of reorganization and at some subsequent date?

The assets of industrial corporations are subject to fluctuations in value. It has not been established that such valuations may be made with certainty. The meaning of the valuation requirement under the law controlling Chapter X should be answered with regard to these questions:

1. Is the valuation a precise amount or a range?

2. Is the valuation found a minimum or a maximum?

The chief method used in the valuation of industrial corporations is the capitalization of reasonably anticipated earnings. This method, however, should yield different results, depending on the assumptions made. The questions raised are:

1. To the extent the capitalization of earnings method is used by the S.E.C., do the assumptions it makes result in equitable treatment of security holders?

2. Assuming that the capitalization of earnings at a single rate is an appropriate method of valuation, are there specific steps which may be taken to improve its application?

Chapter X of the Bankruptcy Act requires that the plans of reorganization be fair and equitable. This requirement raises the following questions:

1. What are the legal requirements of fairness and equity?

2. What are the specific rules and order of priority under the absolute priority rule?

3. How has the S.E.C. utilized legal doctrine to approve and disapprove specific claims?

Chapter X of the Bankruptcy Act requires that plans of reorganization be feasible, as well as fair and equitable. The following questions are raised:

1. What are the specific feasibility standards of the Securities and Exchange Commission?

2. How has the Commission applied these to approve or disapprove specific plans of reorganization?

In some cases, feasibility requirements may result in simplification of capital structure. Consequently, old security holders may receive securities unlike those they surrender. A qualitative step-

down in priority requires a quantitative step-up in order to constitute full compensation under the absolute priority rule. In this process, there may often be little value remaining for junior interests. An examination of Commission approved plans will show the claims satisfied by the distribution of securities. The following questions should be answered:

1. What type of plans result in the most equitable treatment of each class of security holder?

2. Has the S.E.C. approved types of plans which are most equitable to all interests?

The absolute priority rule applies to reorganizations conducted under different statutes. The following questions are raised:

1. Do doctrinal and statutory distinctions require or allow different approaches to the application of the absolute priority rule?

2. Do the reorganization procedures followed in other settings have any implications for modification of Chapter X reorganization procedures?

3. Are there any procedural or legal reasons for not making modifications which might improve the valuation methodology and the distribution of securities in Chapter X reorganizations?

The capitalization of reasonably expected earnings is the most common approach to valuation of industrial properties, and its use as a basic approach by the S.E.C. is not questioned. However, there are several possible approaches to valuation based on the capitalization of earnings, and these may yield different results. The following questions are raised:

1. Would the capitalization of earnings at a rate suitable for interest on debt securities, and the capitalization of the remaining earnings at a rate suitable for equity securities, yield a different valuation than capitalization of all earnings at a single rate?

2. Would a capital structure containing a maximum feasible quantity of debt securities yield a higher valuation than some other capital structure, due to the savings in Federal income tax on the debt securities?

3. If a larger quantity of debt in the capital structure would produce a different valuation, what are the factors which limit the quantity of debt?

The absolute priority rule under Chapter X requires that liquidation values of securities be recognized and compensated. Present market value of securities is of no consequence if it does not exceed liquidation value. The following questions are raised:

1. May a larger variety and quantity of securities in the capital structure produce a larger total valuation by providing a larger market value for the securities?

2. Would a larger market value of securities minimize the cost of capital, given a certain level of earnings?

The procedural and legal requirements for an expedient reorganization may require solutions which are not entirely equitable. This possibility raises the following questions:

1. Are there any procedural and legal means to expedite reorganizations and still provide equitable treatment?

2. What changes in laws may provide for both expedient and equitable reorganizations?

Methodology and Resources

The principal methodology in this dissertation is to critically analyze the performance of the Securities and Exchange Commission in Chapter X reorganization of industrial corporations. An attempt is made to answer all substantive questions raised in the previous section and, also, subsidiary questions which have an important bearing on valuation and the distribution of securities in corporate reorganization under Chapter X. Emphasis is placed on examination of the valuation

methodology of the S.E.C. as revealed in advisory reports in cases of reorganization of industrial corporations. These reports will be examined in the light of the precedent legal cases concerning corporate reorganization and by reference to the leading writers in the fields of valuation and corporate reorganization.

The principal sources of information as to the Securities and Exchange Commission methodology under Chapter X are the Advisory Reports (4), and Corporate Reorganization Releases issued under various dates. The Commission's comments in different situations should reveal patterns of treatment which the Commission follows. This may be substantiated by other writings in the learned journals and standard reference books.

The Federal statutes and the reports on decisions of the Supreme Court and other courts provide information on various aspects of corporate reorganization law and doctrine. Financial data have been determined or verified by reference to the manuals of the principal financial services.

CHAPTER II

THE DEVELOPMENT OF CORPORATE REORGANIZATION LAW AND DOCTRINE

Before examining the application of the absolute priority doctrine to claimants in corporate reorganizations, it will be helpful to develop the meaning of this doctrine and briefly trace its development.

Early History of Bankruptcy and Reorganization

In a sense, the absolute priority doctrine had its beginning with the first laws and procedures for the relief of indigent debtors, for it is in the distribution of the assets of such debtors among various classes of creditors that the problem arises. This history of such laws has been traced by several writers (5) (6, pp. 423-436, 446-455) (7). The importance of laws of this character to the Founding Fathers is rather conclusively established by the fact that the Constitution reserved to the Federal Government the power to pass laws governing bankruptcy. Article I, Section 8, paragraph 4, of the Constitution of the United States provides that "The Congress shall have Power . . . To establish . . . uniform Laws on the subject of Bankruptcies throughout the United States" (8, p. 1001). Congress used this power sparingly until 1898. Prior to that date such action taken was generally for temporary relief and laws remained on the statute books for relatively

short periods.*

In 1898, Congress passed a bankruptcy act (1:30;544-566) which, with many revisions and amendments, has remained on the statute books. This law, as originally passed, was quite limited in its scope. Corporations were excluded from the voluntary provisions. It was amended in 1903 (1:32;797-801) to include mining corporations in the involuntary provisions. It was amended again in 1910 to entitle corporations to voluntary proceedings (1:36;839-840).

Liquidation, rather than reorganization, was the purpose of the Act of 1898. It was based on the principle that, upon failure, the assets of a debtor belong to the creditors. Since only the creditors were involved, it was presumed their self-interest in the administration of the assets would guarantee fair treatment for all.

Corporate Reorganization Under Equity Receiverships

The earlier bankruptcy statutes were concerned largely with the individual debtor. If a corporation failed to pay its debts, the creditor could rely on the foreclosure and creditor's bill. The use of this technique resulted in the sale of the assets and the distribution of the proceeds, as far as they would go. The creditor was dependent on the sale attracting enough bidders to bring a satisfactory price. If the bids were not high enough, the creditor could "bid in" the property himself.

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*National bankruptcy laws were passed in 1800, 1841, and 1867. Charles Warren provides a complete account of the reasons for passage, the provisions and the effects of these laws in his book, Bankruptcy in United States History.

In the case of large corporations, particularly the railroads, the remedies available in case of failure were not satisfactory. Carrying through foreclosures according to the terms of the lien would often have resulted in dismemberment of the property, with resultant adverse effects on the public, as well as on creditor and debtor. The offer of the creditor simply to take over the property would not usually work in the case of the railroads, because of the numerous claims of creditors, arising from the successive layers of mortgage bonds issued by the railroads. Thus, the problem was considerably different from the simple sale of a house or a farm.

To cut through these problems, an equity court in Georgia, in 1845, directed the sale of the properties of a railroad as an entirety, free and clear of liens, with the creditors receiving the proceeds. This, according to Dodd and Billyou, was the beginning of equity receivership reorganization (9, pp. 1-2). For purposes of this study, the history of the evolution of equity receivership need not be repeated. Accounts have already been written by Swaine (10, pp. 901-931), Dewing (11, pp. 1331-1354), Daggett (12), Buscheck (13, pp. 964-970), Finletter (14, pp. 1-21), and by the Securities and Exchange Commission (15, pp. 10-60).

Defects in equity receivership procedures

Certain defects in the procedures of equity receivership gave rise to pressures to pass statutes dealing with reorganization. The utilization by management of a "friendly" unsecured creditor to initiate proceedings in anticipation of foreclosure by unfriendly mortgage bondholders enabled the management to retain a degree of control over

the proceedings. Appointment of the president or some other officer of the corporation as receiver was very common (15, p. 33). This enabled the old management to not only cover up past misdeeds, but also to push through a plan of reorganization favorable to themselves.

Formation of protective committees.- Protective committees were usually voluntarily formed. It was necessary to have a majority of the outstanding securities deposited in support of the committee and its plan for the particular protective committee to be recognized. The agreements between committees and security holders, according to Dodd and Billyou, became "standard in form and vested broad powers in the committees with broad exculpatory clauses" (9, p. 3). Oftentimes, the committees began their operations before the friendly creditor brought suit. Naturally, this involved some degree of collusion between the management of the debtor corporation and either investment bankers, commercial bankers, trust officers, or large investors in the company.

Formation of reorganization committee.- The receiverships and reorganizations which involved the large railroad insolvencies of the period following 1913 developed a certain pattern (9, p. 3). Protective committees were formed by the investment bankers who had sold the most recent bond issues. Then, at their direction, engineering studies were made, after which they wrote a plan of reorganization and submitted it to the protective committees. Since these committees were friendly to the bankers, it could be expected that this was the plan to be offered to security holders. Under these circumstances, little opposition developed and this could usually be handled by the superior forces. While the reorganization committee was formed from the leading protective committees, the investment bankers who had sold the last security issue

were usually the managers. While the name "protective committee" suggests protection of all the interests, the reorganization plan was often ready-made.

The treatment of dissenters.- The practice of the courts in setting a minimum bid or "upset price" was designed to eliminate deficiency judgments, but, also, to pay off those who did not assent to a plan of reorganization. However, the only bidders were usually those who had proposed the plan, since they could use their old securities as a substantial portion of the purchase price. Thus, if the "upset price" were arbitrarily set low, dissenters would be forced to accept an inadequate price for the securities. On the other hand, securities were often acquired cheaply to create a nuisance value for them, thereby forcing too favorable treatment of dissenters.

In addition to these largely procedural defects, failure of the courts to evolve satisfactory solutions to the problem of fairness was in the background of the general dissatisfaction. Since most of the corporate reorganizations in the United States during the first three decades of the twentieth century were effected through equity receiverships, these defects gave rise to pressures to pass statutes dealing with reorganization. This will be treated after an examination of the doctrine of fairness and equity as developed in equity reorganizations.

The Development of Priority Doctrine

Corporate reorganization is importantly concerned with how much cash and/or securities the various claimants are to receive as a result of the financial reconstruction of the old corporate structure. Arthur S. Dewing discusses the uncertainties surrounding the meaning of the

word reorganization (11, pp. 1282-1284). Similar, but more confounding, difficulties are encountered with respect to the meaning of priority in reorganization, even though the generic meaning of priority is clear. In reorganization history, priority was not defined, but rather was applied as a principle under various legal circumstances. Priority in reorganization is now taken to mean the ordering of claims according to contractual and legal rights. Even this definition will be subject to conflicting views with respect to absolute and relative claims on assets and income. A discussion of these conflicting views will be presented in the next section. However, for the present, attention will be given to evolution of the specific measures of priority in reorganization which became known as the equity standards of fairness. A preponderance of the legal doctrine governing the equity standards of fairness was provided by the large railroad reorganizations under equity receivership.

The Boyd case

The early landmark case for priority doctrine was the Boyd case (16). Boyd, a general creditor, had received no participation in the reorganization, while common stockholders had received participation upon supplying additional money. Boyd sued the reorganized company, alleging that the foreclosure sale was void as to his interests. The court allowed him to recover from the new company on the grounds that the foreclosure sale constituted an agreement between bondholders and stockholders which was fraudulent as to the creditors.

Mr. Justice Lamar delivered the majority opinion in the Boyd case and stated "if purposely or unintentionally a single creditor was not paid, or provided for in the reorganization, he could assert his

superior rights against the subordinate interests of the old stockholders in the property transferred to the new company" (16, p. 504). The Supreme Court held that stockholders could not participate unless junior creditors also had an opportunity to participate, and rejected the argument that the rights of unsecured creditors depended on the property having a value greater than the foreclosed mortgage (16, p. 507).

The Boyd decision, according to Swaine, was an application of the "well established equitable doctrine that a court of equity will not permit the exercise of a legal right in such a manner as to produce an inequitable result" (10, p. 903). He asserted that it had definitely been foreshadowed by the legal theory expounded by Mr. Justice Brewer in the Monon case in 1899 (17). In the latter, the Supreme Court reaffirmed the rule that the rights of first the secured creditors and then the unsecured creditors are superior to those of the stockholders. The dictum of the Boyd case follows logically from that of the Monon case.

However, in the Boyd case, the Court went further in stating that relief would not be available to a creditor who "declines a fair offer" or has "refused to come into a just reorganization" (16, p. 508). The opinion stated that it was not required to pay an unsecured creditor in cash, as the interest could be "preserved by the issuance, on equitable terms, of income bonds or preferred stock" (16, p. 508). The legal doctrine of the Boyd case was based on a general equitable principle and was subsequently applied in cases involving industrial corporations. It is usually conceded that it defined the relationship between creditors on the one hand and owners on the other. The case failed to

settle many questions of fairness between and within classes of security holders. These remained to be settled by much later cases.

In the years following the Boyd case, the concept of the fair plan developed slowly. Early decisions such as those in the Missouri Pacific (18), Frisco (19), and Rock Island (20) cases were importantly concerned with procedural aspects of reorganization. These cases paid some attention to fairness through the recognition of priorities which had begun with the Monon and Boyd cases, but provided no precise test of the fairness of a proposed plan.

The Kansas City Terminal Railway case

The most precise statement of the requirements of a fair plan as of its time was the decision in the 1926 Kansas City Terminal Railway case (21). The most common problem in the early railroad cases was the "freezing out" of junior or unsecured creditors, while common stockholders were permitted to participate upon payment of an assessment. In the case at hand, the creditors were offered new securities of the same grade, though in larger amounts than the stockholders. The Supreme Court was asked to answer three questions related to the matter (21, pp. 452-453). The Court decided that a plan of reorganization should give priority to the entire claim of unsecured creditors over any part of the claim of a stockholder.

The Court, also, said that such a plan would be fair if it offered securities of the same grade, but in larger amount than those offered to stockholders, if such an offer is all that could be reasonably expected under the circumstances. Still, the Court said, "the primary right of unsecured creditors to the assets of an insolvent corporation remaining after lien-holders are satisfied, must be

adequately protected" (21, pp. 455-456). The Court further stated that "no offer is fair which does not recognize the prior right of creditors . . . but circumstances may justify an offer of different amounts of the same grade of securities to both creditors and stockholders" (21, p. 456). Where stockholders may participate by the payment of an assessment or a relatively larger assessment than unsecured creditors, this fact may justify their participation to the extent to which they have contributed new money to the corporation (21, p. 455).

The equity standards of fairness

The principles developed by these and other cases are known as the equity standards of fairness. The Boyd case made it possible to give participation to lower ranking securities without first paying cash or its equivalent to a senior class. If creditors received income bonds or preferred stock, the stockholders could be included. The Boyd doctrine did not require that the senior claimants receive new securities possessing full preference as to principal and interest over new securities given to junior interests.

In voting for a plan, a senior class might agree to modify its rights in the interest of the corporation. It could have its right to fixed interest or dividends changed to a contingent charge in order to prevent a drain on cash. Other modifications could be made in the name of harmony. One particular class of security may have been recalcitrant in the negotiations and, hence, have required special consideration in the provisions for them in the plan. Such compromises did not invade the rights of the minorities of the affected classes, and would be confirmed by the courts, after a determination that the trading of rights was fair and compensatory (14, p. 410).

Under the standards developed to carry out these reorganizations, rights could be modified to the extent necessary to attain simplification of capital structure (feasibility) and to raise "new money." Changes were seldom effected without the award of some quid pro quo. In a few cases, changes were effected without this "one thing in the place of another" on a ground unique to the particular security, e.g. very early maturity. Generally, however, any step down in priority was to be compensated.

Absolute versus relative priority

Under the equity standards of fairness, priority rights could legally be given up by both secured creditors and unsecured creditors, with their consent, and this was often done in the interest of achieving a workable plan of reorganization. Compensation for the reduction of claims through the award of some quid pro quo tended to facilitate such changes in priority rights. This process would be especially attractive, if junior claims could be preserved through generous new claims on possible income rather than through absolute new contractual or liquidation rights. Proponents of this interpretation claimed considerable legal basis in the cases, as well as practical and financial advantages. Such an interpretation is generally termed relative priority or relative income priority as opposed to absolute priority.

Definitions.- The theory of relative priority seems to have been discussed first by Messrs. Bonbright and Bergerman in an article in 1928, in these words:

> According to this doctrine, all that the first mortgage bondholders are entitled to is an exchange of their old securities for new securities, (a) with an approximately equal income claim (in the form of fixed or contingent charges) and (b) with priority over any new securities issued in exchange

> for the old junior securities. This latter condition does not apply to new securities issued to the old stockholders or creditors in exchange for a cash assessment, as such securities may be given a priority even over the securities issued in exchange for the old first mortgage bonds. The reason for this exception is that since the new capital will benefit all security holders together, it may properly be given priority over all (22, p. 131).

According to Billyou, the term absolute priority had not been used by the courts prior to 1928 (23, p. 481). He attributes the first use of the term to Bonbright and Bergerman, who interpreted it to mean that old creditors in the order of their legal priorities should receive new securities of fair cash value roughly equal to their old claims. The term absolute priority as generally understood today has been stated as follows:

> In the distribution of values of a corporate successor to the debtor undergoing reorganization all claims must be satisfied in the order of their legal priorities in accordance with the laws of bankruptcy. This means that secured creditors must be satisfied by the underlying values assignable to the secured assets and any residual claim thereafter treated as a general claim, that junior creditors with unsecured claims must be satisfied out of the general free values of the debtor, and that only after all creditors have received full value for their claims, including interest arrears, can the holders of preferred and common equities, each in their turn, receive recognition of their interests in the debtor (24, p. 19).

Under the absolute priority theory, creditors' claims would be paid in full, in cash or new securities, before any junior interests might participate. According to Gilchrist, "this view has regard for the contractual rights of creditors as distinguished from their property rights in the debtor estate" (25, p. 594). This is the fundamental rule of real estate mortgages. A first mortgage holder is to be paid the full amount of principal and interest before any junior lienholder can participate upon foreclosure. When applied in reorganizations, this

means that the first mortgage holder should receive cash or the equivalent in new securities to the full face amount of the claim, plus any past due interest, before a junior claimant may receive any new securities, except with respect to unpledged assets.

Extent of application.- Messrs. Bonbright and Bergerman reported on an analysis they made of ten large railroad reorganizations. As a result of their analysis, they reached the following conclusions:

> First, the principle of absolute priority rights, whereby the senior security holder gets the full return of his investment before the junior security holder gets anything is constantly violated in railroad reorganization, and this violation extends beyond the point of allowing junior holders to participate to the extent required by the necessity of raising capital . . .
>
> Second, there is a distinct tendency for reorganizations to distribute the new securities in part on the basis of the relative income position doctrine rather than on the absolute priority doctrine. This tendency, however, is by no means carried to its logical conclusions, and the very same reorganizations will generally contain some provisions that are in harmony with the relative position doctrine, other provisions that are consistent only with the absolute priority doctrine, and still other provisions that cannot be squared with any formula of priority rights that has ever been suggested . . .
>
> Third, the chief points of departure of reorganization practice from a complete adherence to the doctrine of relative income position are these (a) Where a senior defaulted bond is to be exchanged in whole or in part for securities with only a contingent charge there is a frequent though not an invariable practice of offsetting the weaker nature of the security, to some extent, by the possibility of a larger annual income. This is a partial reversion to the absolute priority doctrine. (b) Where the maintenance of the old relative positions of security holders would result in continuing an unduly stratified financial structure, the number of preferential ranks may be cut down, and the preferences of certain senior security holders may be observed by an exchange for a larger amount rather than a better quality of new securities. (c) Stockholders generally and junior bondholders occasionally are either completely wiped out, or else are granted a participation only on condition that they pay a cash assessment in exchange for new bonds or new preferred stock worth less than the amount of the assessment. Even on payment of an assessment, preferred stockholders seldom retain their preferential position over common stockholders . . . (22, pp. 144-145).

The authors also found that the junior bondholders, unsecured creditors, and preferred stockholders fared well in these reorganizations due to the probable influence of certain legal decisions, including the Boyd case.

Practical considerations.- Robert T. Swaine, among other proponents of the relative priority rule, argued that it was not practical in most reorganizations to give new securities worth par to the mortgage bondholders on the ground that there would be few securities left to entice stockholders to pay their assessments (10, p. 901). In many cases the principal problem in rehabilitating a corporation was that of securing additional financing, usually at the outset. Those in favor of the relative priority theory felt that in order to secure "new money" the securities offered had to be used as a lure. In their interpretation, this demanded that the suppliers of the "new money" be given priority in the form of a lien ahead of the old creditors.

Equity.- Bonbright and Bergerman seemed well convinced of the equity of the absolute priority rule. They concluded that the relative income rule tended to facilitate reorganizations, but could not be applied in these cases without modifications. These modifications were, first, a reduction in the number of levels of securities and, second, the making of participation by equity interests and even junior bondholders and creditors contingent on a cash assessment. These authors believed that the pertinent question was not whether the law should give its unqualified support to one or the other theory, but rather that the courts should be consistent. Bonbright and Bergerman seemed to favor a compromise between the two theories as evidenced by the following statement:

> It may be that a formula can be evolved which secures the desired compromise between the absolute priority doctrine and the relative income position doctrine, but which at the same time leaves the position of each security holder less ambiguous and less subject to the arbitrary or self-interested decision of those parties who dominate the reorganization policy (22, p. 164).

By 1937, Bonbright had come out very definitely in favor of the absolute priority theory (26, p. 867, n. 64). His main point then was that the relative priority doctrine required a hierarchy of new securities and that this illogical kind of capital structure had been the cause of much of our financial woes in the past. He felt that middle ranks of securities should be given protection against possible collusion between senior security holders and stockholders, but that every effort should be made to fully compensate senior security holders in view of the relatively low rates of return they normally received. His attitude probably reflected the much more pessimistic outlook for railroads at this time than had existed earlier.

Financial effects.- Bonbright and Bergerman concluded that the rights of the senior security holders were violated regularly, whether as a result of the operation of the inducement to assessment or not. This suggests the operation of the relative income priority rule in most cases, although it might not be recognized as such. The courts, in many cases, permitted the granting of priority equal to or above secured creditors to those who paid the assessments, as an inducement to secure the new funds. While the exact quantity of securities necessary would be difficult to determine in any case, it was often quite liberal as dispensed by the lower courts. In any event, the present and potential value of the new mortgages and common stock would have to exceed the amount of the assessment, since the old stockholders were not required

to pay the assessment.

The market value or present value was the test of compensation in accordance with the absolute priority rule at the time. The rule as now interpreted would require full compensation in cash or new securities with both liquidation values and claims on income equal to the old claims. If market value equaled the face amounts, it would be coincidental. However, under the market value test as applied, lip service could be given to liquidation values, but if the securities were excessive in relation to underlying value, the new securities could quickly drop in price below their reorganization value. This would be true for those new securities whose stated claims on income were equal to those of the old securities, if the estimate of future earnings were too optimistic. This procedure could produce the results witnessed by Bonbright and Bergerman, even while the reorganization authorities believed they were observing absolute priorities.

In most cases, due to market fluctuations, the distribution could not be made with any degree of exactitude. As a matter of law, exactitude was not required. The absolute priority doctrine could be satisfied by the issuance of securities whose "present value" equaled the value of the surrendered rights. However, in the ten large railroad reorganizations studied by Bonbright and Bergerman, in only one case "did first mortgage bondholders receive securities worth at the time of reorganization the full amount of their claims and in only three instances were they ultimately made whole by the market value of their securities" (22, pp. 147-148).

The creditors' inclination to sign away these rights was probably to be found most often in those cases where the going concern value

far exceeded the liquidation value. If the corporation were insolvent, of course the bondholder could have satisfied his claim to the full extent of the assets available for the particular mortgage. This, however, would bring in all the unsecured creditors insofar as the free assets were concerned. In a strict application of the absolute priority doctrine, mortgage bondholders might well lose more in liquidation than in a reorganization following the relative priority rule.

Evaluation of the absolute and relative priority theories.- Most of the important cases subsequent to the Boyd decision are adjudged to have failed to develop a satisfactory doctrine of fairness and equity in at least two important respects. First, while generally ordering that certain rights would be recognized, they were less clear as to the manner in which the distribution was to be accomplished. Second, the cases generally provided little information as to the valuation on which the issuance of new securities was to be based.

There was also some question of the real meaning of the Boyd case, which seemed to support to some extent both the absolute and relative priority positions. It was universally agreed that intermediate creditor rights must be recognized, but the court did not state the nature of the "fixed principle." The preservation of interest by the "issuance, on equitable terms, of income bonds or preferred stock" would support the "relative income priority" theory. The fixed principle concerned the classes who were to receive recognition, not how much each would receive.

Widespread support for the relative priority theory was found in the Missouri Pacific case (18). In the opinion, Judge William C. Hook, of the United States Circuit Court for the Eighth Circuit, said:

> They [the stockholders] will pay more than they will get in value; but if they paid nothing and received no bonds, still the relation between them and general creditors would not be disturbed. Besides, the raising of money from some source is imperative, and that raised from the stockholders will be for the benefit of the enterprise as a whole (18, p. 818).

The same general issue of too favorable treatment to stockholders at the expense of creditors was raised again later and the order of the District Court approving the plan was sustained by the Circuit Court (27). It was held that a fair offer was made to the old creditors which maintained the relative position in the new company and that no showing was made as to how money could be raised to pay them in full for their old securities (27, p. 44).

The same attitude was expressed in the 1918 Frisco case (19). The Circuit Court of Appeals sustained the lower court in its confirmation of the sale, stating:

> There is no moral turpitude, nor is there any illegality in the making and performance of an agreement between the bondholders secured by mortgages, the stockholders, and the unsecured creditors of an insolvent mortgagor, that there shall be a foreclosure and sale of the mortgaged property to or for the benefit of a new corporation in which all the members of the three classes shall be permitted at the option of each of them to take the bonds or stock of the new corporation in substantial proportion to the respective claims and equities of the classes. Indeed, a foreclosure and sale under such an agreement is the most practicable, equitable and beneficial method of foreclosure and sale of vast railroad properties that has yet been devised (19, p. 133).

The absolute priority doctrine could have been satisfied only by making the total amount of all securities given to each class in legal order prior in both liquidation rights and income position. New claims on income would have to be equal to old claims. Such a stringent requirement would be difficult to observe when the corporation was worth considerably more as a going concern than in liquidation by the addition

of relatively modest amounts of new money. It is not too difficult to understand why bondholders themselves did not supply the new money. Their traditional position as mortgage holders would have been altered through the ownership of the common stock. The equity owners were in a much better position to secure the funds and take the risks, in those days of rather free wheeling high finance. The procedure of reorganization was intimately associated with investment banking, which in turn was associated with concentration of wealth and control of industry.

Under both the absolute and the relative priority rule, the new valuation became the total quantity of securities authorized. Under both rules, the assessment system encouraged the authorization of liberal quantities of securities to assure that a place was given to intermediate classes of claimants in the reorganization. Under the relative income priority rule, the generous issue of contingent income securities was further encouraged.

Sections 77 and 77B of the Bankruptcy Act

Since 1920, the Interstate Commerce Commission has been empowered to approve or disapprove every issue of railroad securities. However, the I.C.C. did not exercise this power in a manner to prevent widespread and recurrent railroad failures. In a move designed to correct this situation, the National Bankruptcy Act was amended in 1933 with Section 77 which applied to the reorganization of railroads (1:47; 1474-1482) (1:49; 911-926, 1969-1971). Under Section 77, the plan of reorganization had to be sanctioned by the Interstate Commerce Commission. Both the court and the I.C.C. had control over the plan of reorganization while it was being prepared and while the road was in the

hands of the trustee, who, under Section 77, replaced the equity receiver. Dissenters were required to accept the plan, eliminating the need for cash to pay off their claims. In 1934, Section 77B was passed and provided for the reorganization of corporations other than railroads, insurance companies, and banks (1:48;912-925) (1:49;664). Since this dissertation concerns treatment of security holders in reorganizations of industrial corporations, Section 77B rather than Section 77 will be examined at this point.

Improvements in Section 77B

In some respects, Section 77B was a definite improvement over equity receivership. It did away with ancilliary proceedings by having the property centralized in the reorganization court. It permitted "new money" to receive priority in reorganization through the issuance of trustees' certificates. The courts were given greater control over the expenses and conduct of committees. They were also given power to examine proxies and deposit agreements, and the motives of all who sought to participate in or be paid from the proceedings. Section 77B made acceptance of a plan of reorganization by two-thirds of each class of creditors, both secured and unsecured, and by a majority of stockholders binding on all classes of security holders. This eliminated the payment of cash to dissenters.

However, under 77B, the fact that the required majorities of security holders approved the plan did not validate the plan as fair and equitable. The court was required to make a finding of fairness and equity and was to be prepared to defend the rights of any aggrieved by the proffered plan.

In the view of Finletter, the standards of fairness applicable

in equity receivership were incorporated into Sections 77 and 77B (14, p. 389). The term "fair and equitable" was included in both the equity cases and in Sections 77 and 77B.

Defects in Section 77B

Certain serious defects were present in Section 77B. Under this Section, which continued to allow the voluntary petition, action by an unfriendly creditor could be prevented and the debtor could continue in possession. The trustee was merely a conservator in that there was no provision for his participation in the formulation, submission, or consideration of the plan. The Section still left all the room for bargaining among contending groups and it did not eliminate insider activities. Considerable control was exerted by investment bankers. One investigator found that of 341 protective committees and 105 reorganization committees organized from 1931 to 1935, 232 had banker majorities and 32 had banker minorities (28, p. 337).

There was no effective provision for a disinterested party to determine the real causes of failure. Neither the judge nor trustee was so impowered, and the information on which such a judgment could be based was usually not forthcoming from reorganization committees. While the approval of a plan of reorganization was conditioned on a finding of fairness, equity and feasibility, the plan was often based either on unwarranted optimism as to the earnings prospects, or a desire to include as many as possible of the old security holders in the new corporation. According to Jerome Frank, it was not unusual for Section 77B proceedings to be "used as a 'short receivership', and pressure on the judge to 'go along' in such situations was great" (29, p. 332).

Due to the bankruptcy origin of Section 77B, there was a strong

inclination to follow the composition principles of the Bankruptcy Act (30, p. 1408). In the case of Downtown Investors Association versus Boston Metropolitan Buildings, Incorporated, the Circuit Court of Appeals for the First Circuit originated the dictum that the principles of fairness and equity as developed in equity receiverships were not applicable to proceedings under Section 77B (31). Cases introduced in some eastern courts followed this dictum throughout the remaining life of Section 77B, according to Gilchrist (25, p. 600).

Section 77B was passed rather hurriedly in a period of a tremendous number of failures. During the four years it remained in effect, reorganizations involving many large corporations were initiated. Section 77B was passed in response to the general dissatisfaction with the equity receivership. However, it fell short of supplying a satisfactory reorganization statute. In many ways, Section 77B was merely a step toward Chapter X, which replaced it. However, Section 77, governing the reorganization of railroads, remained in effect.

Chapter X of the Chandler Act

Work of the study committees

While Section 77B was in effect, studies had been under way for some time by the McAdoo Committee and by the Sabath Committee to find ways to improve our bankruptcy laws. The Securities and Exchange Commission was authorized and directed to make a study of the activities of protective and reorganization committees, pursuant to Section 211 of Public Law No. 291, 73rd Congress, Securities Exchange Act of 1934 (1: 48;909).

During the period, the S.E.C. had been working closely with

Congressman Walter Chandler of Tennessee, Chairman of the House Committee on the Judiciary, on the draft of a bill to completely revise and amend the Bankruptcy Act of 1898. Bills had been introduced in Congress in 1936 and 1937, and the Chandler bill was passed in 1938 (32, p. 56). Chandler, as chairman, had stated "it is evident that Section 77B cannot satisfactorily be patched up . . . it must be completely rewritten. The defects . . . are dealt with and corrected in Chapter X and provisions relating the Securities and Exchange Commission to reorganization proceedings have been carefully drafted and woven into the procedure" (32, p. 56).

The provisions of Chapter X of the Act

While certain changes applying to debtor and creditor relationships were made by other Chapters of the Act, the provisions applying to certain publicly held corporations are found in Chapter X (1:52;883-897) (1:54;709-710) (1:60;331-332). The main interest in this dissertation is in the provisions related to fairness and equity and feasibility and to the role of the S.E.C. in reorganizations instituted under Chapter X. Details of the general procedural provisions of Chapter X may be found in writings by Howard L. Oleck (33, pp. 323-349), and Charles E. Nadler (34, pp. 693-694).

These provisions gave the courts much more control over the procedure, the plan of reorganization, and the security holders and their representatives. Another effect was to give the disinterested trustee a much more important role to perform with respect to the actual plan of reorganization than was possessed by the receiver in equity and the trustee under 77B. Surveys of the effects of these changes on various aspects of corporate reorganization are numerous and are brought into

this dissertation at the appropriate places. The remainder of the discussion in this section is confined to the requirements for a fair and equitable plan and to the role of the S.E.C. in Chapter X cases.

Requirements for fairness and equity and for S.E.C. participation

After the hearing on any plan of reorganization and before the approval of any plan, the judge may, if the scheduled indebtedness of the debtor does not exceed $3,000,000, and shall, if such indebtedness exceeds $3,000,000, submit to the S.E.C., for examination and report, the plan or plans which the judge regards as worthy of consideration (1:52;890-891). The judge shall not enter an order approving such a plan until after the S.E.C. has either filed its advisory report or failed to do so within a time fixed by the judge (1:52;891). Thereafter, the judge shall reject the plan, or approve it if he finds it "fair and equitable and feasible," and shall fix a time for the parties affected thereby to accept it (1:52;891).

The trustee or the debtor in possession then transmits to all creditors and stockholders copies of the approved plan, the opinion of the judge and the advisory report, if any, of the S.E.C. (1:52;891). Up until this time, no person has a right to solicit even a conditional acceptance of the plan without the consent of the court (1:52;891). Chapter X requires that there be provision in the plan for any class of creditors in which two-thirds of the class do not accept the plan, protection of the interests of dissenters if the corporation is solvent, and fair provisions with respect to terms, priorities, and rights of all classes of security holders.

Confirmation of the plan

After acceptance by two-thirds in amount of the allowed classes of creditors and majorities of the allowed classes of stockholders when the corporation is not insolvent, a hearing is held for consideration of confirmation of the plan and of objections thereto (1:52;892). The judge shall confirm a plan only if satisfied that it is fair and equitable, and feasible (1:52;897).

Role of the S.E.C. under Chapter X

Technically, the S.E.C. is highly restricted in its role with respect to corporate reorganizations under Chapter X to serving as a party to the proceedings and to rendering advisory reports when required.

Party to the proceedings.- The S.E.C. has stated that in the development of administrative law the Commission's functions under Chapter X possess aspects to some extent novel:

> In the first place, its work in this sphere is done as a party to the proceedings before the court. The Commission does not initiate proceedings or hold its own hearings, nor has it the power to adopt rules and regulations governing these cases. In the second place, the Commission's functions under Chapter X are purely advisory in character. It has no authority under the Act either to veto or to adjudicate any of the other issues arising in a proceeding. Nor has it the right of appeal. The facilities of its technical staff and its disinterested recommendations are simply placed at the service of the Federal Courts, affording the latter the views of experts in a highly complex area of corporate law and finance (35, pp. 37-38).

The Commission may become a party to the proceedings in cases when the debts are less than $3,000,000 at its own request. The Commission tends to refrain from becoming a party to the proceedings in cases where less than $250,000 in securities are in the hands of public investors, unless the statute has been importantly violated or an unfair plan has been proposed (35, p. 41). In its investigative procedures in Chapter X cases, the Commission collects information concerning the corporation and its

management through the trustee and other parties to the proceedings, and by examination of the corporation's records (36, pp. 64-65). The Commission is interested in all aspects of cases in which it takes part and actively participates in and influences both the formal appearances and informal conferences (35, p. 42).

Preparation of advisory reports.- Information received from witnesses and the trustee is supplemented by independent research of the Commission's staff. These studies involve general, economic, and industry factors, as well as the particular facts surrounding the corporation's condition, cause of failure and the makeup of both the old and the suggested new management personnel. These findings become the basis for and may be included in the Advisory Reports which the Commission renders. Aside from its general role as protector of the public interest in the purchase of securities, it appears that the main reason for the role given the S.E.C. was that the courts did not possess the expert personnel needed to determine valuation and the other elements making for a fair and equitable plan. The Commission has other roles to perform related to matters such as charters, and claims for allowances. These, however, are minor and not the subject of this dissertation.

Summary

Chapter X of the Chandler Act is to some extent a codification of equity receivership, and certain aspects of the consent receivership. It improved the administrative procedures and eliminated certain defects, such as use of the upset price to pay dissenters. In the absence of mismanagement, the old management and the underwriters are not barred from serving on protective committees. However, at the point of passage of the Chandler Act, their dominance of the proceedings began to

decline. Today, they appear to be of no particular significance in this regard.

Chapter X appears to have gone far toward safeguarding all the several interests and providing means for examining alternative plans of reorganization from the standpoint of their feasibility and their fairness and equity to all and particularly to public investors. However, while the law requires that the reorganization plan be fair and equitable and feasible, it carefully refrained from defining these terms.

The Los Angeles Lumber Products Case

The tendency of the courts to follow something less than a strict or absolute priority rule was mentioned in relation to both the equity cases and those under Section 77B. This tendency continued in the early days of Chapter X. Numerous 77B cases were still in the courts at the time of the passage of Chapter X. One such case, the Los Angeles Lumber Products Company case (2), has become the landmark for the requirement of absolute priority under Chapter X of the Bankruptcy Act. As shall be brought out presently, the connection of Chapter X to the absolute priority requirements of the equity cases is through the term "fair and equitable" which was included in both Section 77B and Chapter X.

Facts and outcome

In this case the debtor was a holding company owning practically all the outstanding stock of six subsidiaries. The principal subsidiary, the Los Angeles Shipbuilding and Drydock Corporation, located in California, had assets of $830,000. The debtor's other assets totaled less than $10,000. Against these assets were liabilities of $3,807,071.88 in interest and principal on first lien mortgage bonds, and a little over

$500,000 in other liabilities (2, p. 109).

Under the plan, the bondholders were to receive 641,375 shares of preferred stock, at a ratio of 250 shares for each $1,000 bond. Class A stockholders were to receive 188,625 shares of common stock without the payment of an assessment. No provision was made for the old Class B stock. The total par value of preferred and common stock to be issued to existing security holders was $830,000. The plan was assented to by approximately 92.81 per cent of the face amount of the bonds, 99.75 per cent of the Class A stock and 90 per cent of the Class B stock. Throughout the Section 77B proceedings, the petitioners objected that the plan was not fair and equitable to bondholders.

The company was clearly insolvent as shown by the following excerpt from the opinion delivered by Mr. Justice Douglas:

> The District Court found that the debtor was insolvent both in the equity sense and in the bankruptcy sense. The latter finding was based upon "appraisal and audit reports." In this connection the court found that the total value of all assets of Los Angeles Shipbuilding and Drydock Corporation was $830,000, those assets constituting practically all of the assets of the debtor and of its various subsidiaries of any value to the estate. Yet in spite of this finding, the court, in orders now under view confirmed the plan. And the court approved it despite the fact that the old stockholders who have no equity in the assets of the enterprise, are given 23% of the assets and voting power in the new company without making any fresh contribution by way of subscription or assessment. The court, however, justified inclusion of the stockholders in the plan (1) because it apparently felt that the relative priorities of the bondholders and stockholders were maintained by virtue of the preferences accorded the stock which the bondholders were to receive and the fact that the stock going to the bondholders carried 77% of the voting power of all the stock presently to be issued under the plan; and (2) because it was able to find that they had furnished the bondholders certain "compensating advantages" or "consideration" (2, p. 112).

The claimed "compensating advantages," or "considerations" were listed under four headings, and were entirely intrinsic. They consisted primarily of the "value" in having the firm continued as a going concern

under the old management, rather than having it liquidated at some cost and inconvenience to the bondholders.

Both the Securities and Exchange Commission and the Interstate Commerce Commission desired certain determinations of the meaning of fairness and equity as used in the statutes. When the case was appealed to the United States Supreme Court, R. H. Jackson, Solicitor General and amicus curiae for the United States, presented the position of the S.E.C. and the I.C.C. (9, p. 41). In the brief, which was filed by special leave of the Court, it was stated:

> Neither the United States nor any agency thereof is a party to this case or immediately interested in its outcome. However, the case involves the interpretation of a statutory standard of vital importance in the reorganization of corporations — the standard by which plans of reorganization effected under the laws of the United States are to be found "fair and equitable." This brief is filed by the United States as amicus curiae in order to urge upon the Court the importance of a definitive judicial interpretation of that standard, and to assist the Court in arriving at such an interpretation . . . . Both the Interstate Commerce Commission and the Securities and Exchange Commission are interested in an authoritative declaration of the principles governing the interpretation of the terms "fair and equitable," as used in the statutes of the United States, not only as such interpretation may provide the guide to the proper recognition of the priority of senior interests over junior interests in reorganization, but also as it may define the limits of the rights of stockholders or junior creditors to participate in the assets of reorganized companies on the basis of contributions of cash or its fair equivalent (9, p. 41).

Opinion of the Court

The court ruled unanimously in favor of the absolute priority rule in statutory reorganization. Mr. Justice Douglas, who delivered the opinion of the Court, was formerly chairman of the Securities and Exchange Commission and had previously expressed himself on the matter of priorities (37, pp. 1009-1041). Some felt that Douglas may have been biased in the favor of his former position and associations; however, in

the decision he had the support of the entire Court. To quote from his opinion:

> In equity reorganization law the term "fair and equitable" included, inter alia, the rules of law enunciated by this Court in the familiar cases of Railroad Co. v. Howard, 7 Wall. 392; Louisville Trust Co. v. Louisville, N.A.& C. Ry. Co., 174 U.S. 674; Northern Pacific Ry. Co. v. Boyd, 228 U.S. 482; Kansas City Terminal Ry. Co. v. Central Union Trust Co., 271 U.S. 445. These cases dealt with the precedence to be accorded creditors over stockholders in reorganization plans (2, pp. 115-116).

The decisions in these cases have been discussed previously in this dissertation, except for the early Howard case. The opinion of Mr. Justice Douglas continued:

> In Louisville Trust Co. v. Louisville, N.A.& C. Ry. Co., supra, this Court reaffirmed the "familiar rule" that "the stockholder's interest in the property is subordinate to the rights of creditors; first of secured and then of unsecured creditors." And it went on to say that "any arrangement of the parties by which the subordinate rights and interests of stockholders are attempted to be secured at the expense of the prior rights of either class of creditors comes within judicial denunciation" (p. 684). This doctrine is the "fixed principle" according to which Northern Pacific Ry. Co. v. Boyd, supra, decided that the character of reorganization plans was to be evaluated. And in the latter case this Court added, "If the value of the road justified the issuance of stock in exchange for old shares, the creditors were entitled to the benefit of that value, whether it was present or prospective, for dividends or only for purposes of control. In either event it was a right of property out of which the creditors were entitled to be paid before the stockholders could retain it for any purpose whatever." (p. 508.) On the reaffirmation of this "fixed principle" of reorganization law in Kansas City Terminal Ry. Co. v. Central Union Trust Co., supra, it was said that "to the extent of their debts creditors are entitled to priority over stockholders against all the property of an insolvent corporation" (p. 455) . . . . As stated in Kansas City Terminal Ry. Co. v. Central Union Trust Co., supra, p. 455; "Generally, additional funds will be essential to the success of the undertaking, and it may be impossible to obtain them unless stockholders are permitted to contribute and retain an interest sufficiently valuable to move them. In such or similar cases the chancellor may exercise an informed discretion concerning the practical adjustment of the several rights." But even so, payment of cash by the stockholders for new stock did not itself save the plan from the rigors of the "fixed principle" of the Boyd case,

> for in that case the decree was struck down where provision was not made for the unsecured creditor and even though the stockholders paid cash for their new stock. Sales pursuant to such plans were void, even though there was no fraud in the decree. Northern Pacific Ry. Co. v. Boyd, supra, p. 504. As this Court there stated, p. 502, "There is no difference in principle if the contract of reorganization, instead of being effectuated by private sale, is consummated by a master's deed under a consent decree" (2, pp. 116-118).

In no decision until this time had the case for the absolute priority doctrine been asserted with such clarity. The doctrine's connection with the Boyd case and its successors was made much more definite by the opinion. To quote further from the opinion of Mr. Justice Douglas in the Los Angeles Lumber Products case:

> In such adjudications the doctrine of Northern Pacific Ry. Co. v. Boyd, supra, and related cases was commonly included in the phrase "fair and equitable" or its equivalent. As we have said, the phrase became a term of art used to indicate that a plan of reorganization fulfilled the necessary standards of fairness (2, p. 118).

The passage then goes on to enumerate cases in which "fair and equitable" and like phrases were used to include the "fixed principle" of the Boyd case, its antecedents and its successors. Hence, the Court concluded, as had other courts, that that doctrine was firmly imbedded in Section 77B. The Court then proceeded to provide the specific details as to why it did not believe that the plan of reorganization was "fair and equitable" within the meaning of that phrase as used in Section 77B.

Principles established

The case established that, in being applicable to Section 77B, the principle of absolute priority doctrine, also, applies to Chapter X, since the "fair and equitable" language is the same in both statutes. It is also clear that absolute priority means full compensation for

contractual legal rights, and that no participation would be continued where no equity remained without a contribution in money or other property (11, pp. 1364-1365). There seemed to be little doubt of the importance of the case or the intention of the administrative agencies to press for the observation of its pronouncements.

The Consolidated Rock Products Company Case

One very important problem was not solved by the Los Angeles Lumber case. Earlier mention was made of the tendency for the reorganization value of corporations to be determined by the quantity of securities to be authorized. By the decision of the Los Angeles Lumber case, it became clear that a more precise valuation would be required to determine when an equity remained for a given class of security holder. It remained for the Consolidated Rock Products Company case to solve this problem, at least tentatively, and others which are almost as important (3).

Facts and outcome

The Consolidated Rock Products Company was a holding company organized in 1929 to take over two competing gravel companies, Union and Consumers. Intercompany books were kept and Consolidated conducted the entire management and financing of the two companies, which had no other stockholders. In 1933 the Union bonds were defaulted and in 1934 the Consumers bonds were defaulted. In 1935 the three companies filed voluntarily under Section 77B. Separate bondholders' committees, as well as a committee for the preferred stock of Consolidated, were formed. It was not until 1938 that a plan of reorganization was confirmed.

The plan was appealed by E. Blois du Bois who held $181,500 in

par value of bonds. However, the Circuit Court of Appeals of the Ninth Circuit confirmed the plan of the District Court on November 4, 1939, two days prior to the decision of the Supreme Court in the Los Angeles Lumber Products Company case. A rehearing was requested immediately by du Bois in view of the new principles established therein. The Circuit Court reversed itself and an appeal was taken to the Supreme Court.

By special leave of the Court, an amicus curiae brief, which took the same position as that which would be taken by the Court in its opinion, was filed by the Solicitor General and joined in by counsel for the S.E.C. (9, p. 60, n. 1). This case involved questions of fairness turning on valuation of the parent company and its two wholly owned subsidiaries (3, p. 679).

The District Court had not found specific values for the separate properties of Consolidated, Consumers, or Union, or for the entire properties. Consolidated had argued that the net value of its property was $1,359,000, including $500,000 of good will. The balance sheet, however, showed assets of $3,723,738.15 and liabilities of $4,253,224.41. The earnings record cast even greater doubt on the estimated values (3, p. 681). The Supreme Court agreed with the Circuit Court of Appeals that it was an error to confirm this plan of reorganization. The opinion, delivered by Mr. Justice Douglas, stated in part as follows:

> 1 I. On this record no determination of the fairness of any plan of reorganization could be made. Absent the requidite valuation data, the court was in no position to exercise the "informed, independent judgment" (National Surety Co. v. Coriell, 289 U.S. 426, 436 . . .) which appraisal of the fairness of a plan of reorganization entails (3, p. 682).

Opinion of the Court

Remarking on the failure to make an adequate finding of value,

Mr. Justice Douglas quoted Mr. Justice Holmes in Galveston, Harrisburg & San Antonio Ry. Company v. Texas, 210 U.S. 217, 226, ". . . the commercial value of property consists in the expectation of income from it" (3, p. 685). It was concluded that earning power was the proper method of valuation for productive properties and any other method was not appropriate. A finding as to whether the reasonably expected earnings may be sufficient to meet the interest and dividends on the new securities was held to be requisite to "a determination of the integrity and practicability of the new capital structure" (3, p. 685).

Creditors were entitled to full compensation, but the method of effecting full compensation for senior claimants would vary from case to case. The Court said that, "so long as the new securities offered are of a value equal to the creditors' claims, the appropriateness of the formula employed rests in the informed discretion of the court" (3, pp. 686-687). The fact that a corporation might substitute one new security in the place of several old securities does not make a plan unfair and inequitable. The question of whether a corporation were solvent in either the equity sense or in the bankruptcy sense had no bearing on the applicability of the absolute priority rule (3, p. 685). A district court did not need first to determine the solvency of a corporation before requiring the application of the rule of absolute priority rights.

Importance of the case

The Consolidated Rock Products case is considered important in that it declared the responsibility of a district judge to make a finding of value as a requisite to approving a plan of reorganization as fair and equitable and, at the same time, established earning power as the main criterion of value. The responsibility for the valuation and

the specific technique to be used were left with the district judges. Furthermore, the exact formulae to be used in distributing new securities were left to the discretion of the lower courts. The full implications of the earning power criterion of value as pronounced in this case will be treated in Chapter III, Valuation Under Chapter X of the National Bankruptcy Act.

Further Development of Priority Theory

Two 1942 companion railroad reorganization cases, the Western Pacific (38), and the Milwaukee (39), stand out prominently in connection with the absolute priority rule. The Western Pacific case is very important in that, among other precedents, it established the responsibility of the Interstate Commerce Commission to develop plans of railroad reorganization primarily in the public interest. The Milwaukee case, among other pronouncements, permitted full compensation to railroad security holders without placing dollar values on what would be surrendered or what would be received. Both cases are important because they represent a legalistic point of departure in the reorganization of railroads and those of industrial corporations. Still, they are in the same general line of cases related to the full compensation doctrine of the Boyd case, the Los Angeles Lumber case, and the Consolidated Rock Products case.

The Milwaukee case

The Milwaukee case was very specific throughout in distinguishing between railroad reorganization principles and general principles. The opinion was rendered by Mr. Justice Douglas, who had presented the opinion in the Los Angeles Lumber Products case and the Consolidated

Rock Products case. Mr. Justice Douglas cited the two above mentioned cases as reorganizations of industrial companies and stated that the rules established therein are equally applicable to a railroad reorganization (39, p. 738). To quote from the opinion of Mr. Justice Douglas:

> . . . Congress when it passed Sec. 77 made earning power the primary criterion. The limited extent to which Sec. 77, sub. e, provides that reproduction cost, original cost, and actual investment may be considered indicates that (apart from doubts concerning constitutional power to disregard them) such other valuations were not deemed relevant under Sec. 77B, 11 U.S.C.A. Sec. 207, "except as they may indirectly bear on earning capacity" (39, p. 738).

It was stated that "a basic requirement of any reorganization is the determination of a capitalization which makes it possible not only to respect priorities in various classes of claimants, but also to give the new company a reasonable prospect for survival" (39, p. 727). The case contained a number of pronouncements concerning specific treatments of income, leases, liens, and new capital structure, some of which will be discussed in Chapter V under the heading of Expansible Value. However, the most important pronouncement from the standpoint of its ultimate effect on priority doctrine is to be found in the following portion of the opinion:

> It is sufficient that each security holder in the order of his priority receives from that which is available for the satisfaction of his claim the equitable equivalent of the rights surrendered. That requires a comparison of the new securities allotted to him with the old securities which he exchanges to determine whether the new are the equitable equivalent of the old. But that determination cannot be made by the use of any mathematical formula. Whether in a given case senior creditors have been made whole or received "full compensatory treatment" rests in the informed judgment of the Commission and the District Court on consideration of all relevant facts (39, p. 749).

The removal of the requirement for finding a precise dollar valuation and the introduction of the term "equitable equivalence" were taken

by some to mean the removal of the requirement of absolute priority. However, the real meaning of these two facts taken together is that the Interstate Commerce Commission, in its regulatory role, is permitted to construct plans of reorganization employing a less strict interpretation of the absolute priority rule than might be indicated by the rulings of the precedent industrial cases.

The Western Pacific case

The Western Pacific case made it clear that the courts are required to accept the valuations and distributions of securities provided in the plans of reorganization of the I.C.C., unless the latter violates the Constitution and acts arbitrarily (38, p. 692). The court may examine plans, hear objections, collect evidence, examine legality, dismiss proceedings and remand the proceedings to the I.C.C. (38, p. 703).

In referring to Section 77, subsection (e) of the Bankruptcy Act, the Supreme Court said:

> The function of valuation thus left to the Commission is the determination of the worth of the property valued, whether stated in dollars, in securities or otherwise . . . . Congress apparently intended to leave the determination of valuation "of any property for any purpose under this section" to the Commission. The language chosen leaves to the Commission, we think, the determination of value without the necessity of a reexamination by the court, when that determination is reached with material evidence to support the conclusion and in accordance with legal standards (38, p. 707).

If the Interstate Commerce Commission allocated securities in such a way as to preserve the priority rights of creditors, the aggregate value of securities issued becomes the total value of the corporation, and, if the Commission's distribution is well considered, the court has no obligation to examine the method whereby the totality of securities distributed was determined. The Supreme Court ruled that the

matter of valuation was entirely within the legislative function of the Commission as affecting the public interest.

Dewing, among other writers in this field, believed that there should be a distinct difference in the legal philosophy which would be used to govern the allocation of securities of corporations with simple financial structures and those with complex financial structures (40, pp. 1320-1325). The former group was typified by the industrial corporation and the latter by the large railroad corporation. It was believed that the former required little or no step-down in priority while the latter required a change in participation in assets, earnings and/or control. It was concluded that the four cases just discussed established rules to accomplish such purposes within the meaning and intention of preservation of absolute priority rights. In other words, if the new securities were equal in value to the old claims, the exact formulae used rested within the discretion of the proper agency charged with a determination of value. This was said to involve intricate problems of valuation, requiring wisdom in the balancing of rights and some degree of compromise in order to achieve fairness. It was felt that these cases expressed this sentiment.

However, it appears that these writers overlooked the distinction between the rules which were to govern railroad reorganizations and those which were to govern industrial reorganizations. It is true that the absolute priority doctrine would be applicable and earning power would be the basis for determining value in both kinds of reorganization. However, in the two railroad cases, it was made clear that the I.C.C. would utilize the valuation procedure in a manner to assure that the public interest would be served by preservation

of most of the interstate railroads. The doctrine of these two cases provided a more liberal and flexible standard than is to be found in Chapter X reorganizations. The courts continued to reaffirm the absolute priority doctrine in subsequent cases by generally citing the precedent cases as a group, whether they were railroad or industrial cases.

It was, also, believed in some quarters that some of the language of the Milwaukee case, in particular, would justify the use of an investment value standard, as applied by the Securities and Exchange Commission under Section 11 of the Public Utility Holding Company Act (1:49;820-823). This view is developed by De Forest Billyou (41, pp. 553-590) (42,pp. 1379-1385), but rejected by Walter J. Blum (43, pp. 1367-1379).

The Otis case

The authoritative use of the investment value standard in P.U.H.C. Act simplification cases was established in the Otis case (44, p. 634). The petitioners in the case attempted to enforce the liquidation rights of their securities. It was held that "when the Commission proceeds in the simplification of a holding company system, the rights of stockholders of a solvent company which is ordered by the Commission to distribute its assets among its stockholders may be evaluated on the basis of a going business and not as though a liquidation were taking place" (44, p. 633).

According to Blum, both the liquidation standard as used by the S.E.C. under Chapter X and the investment value standard used under the P.U.H.C. Act are "part of the absolute priority doctrine" (45, p. 599, n. 49). The essential difference is that in bankruptcy reorganization, the securities are treated as matured as to liquidation rights, while

in public utility holding company simplifications, the rights are not treated as matured. Therefore, in bankruptcy reorganization, senior security holders are entitled to the value of their securities immediately prior to reorganization and to the "equitable equivalent of their entire position, including that part of it which arises from the maturing of their rights on default" (45, p. 599, n. 49). In P.U.H.C. simplification cases, senior security holders are entitled to the equitable equivalence of the value of their securities immediately prior to simplification. Such value is termed the investment value doctrine. The exchange of securities in such circumstances, apparently, considers all the investment features of the old securities in comparison with all the investment features of new securities and relates them to the immediate past value of the old securities and the near term market value of the new securities.

It is difficult to know at this point, whether the investment value standard would provide higher reorganization value for the senior securities of failed industrial corporations than the liquidation standard. All the literature seems to indicate that strict application of the liquidation standard provides senior securities the maximum compensation they could receive under any circumstances. This question will be further considered in Chapter V.

These important cases, between 1939 and 1945, bring out that different reorganization procedures and standards are to govern, depending on the reorganization setting. While the absolute priority doctrine is the law of the land for all reorganization settings, its interpretation is highly modified by the circumstances.

CHAPTER III

VALUATION UNDER CHAPTER X OF THE NATIONAL BANKRUPTCY ACT

The purpose of this chapter is to determine what method of valuation is required by the law, what method of valuation is used by the Securities and Exchange Commission, whether inequities result from its use and whether the courts or the Securities and Exchange Commission are under any obligation to allow for the possibility of error in valuation. Inquiry, also, will be made into the assumptions made by the Securities and Exchange Commission in its valuation, as to their effect on the equitable treatment of security holders. Possible methods of improving the general valuation approach of the S.E.C. will be suggested.

Legal Precedents for Valuation

The connection between the equity and 77B cases and the fair and equitable requirement of Chapter X was demonstrated in the previous chapter. The importance of the Consolidated Rock Products case in requiring a valuation was discussed (3). This case refers to earlier cases which dealt importantly with valuation (3, p. 682). In one such case, involving the reorganization of Morris White, Incorporated, the petition claimed that the assets were more than $4,000,000 and the liabilities about $1,000,000 (46). No appraisal of assets or itemized list of liabilities was made. Mr. Justice Brandeis observed the absence of valuation data and a forecast of the company's prospects. Noting the

fact that lower courts were prone to relieve themselves of the duty of a finding of value in the presence of a high percentage of assents, Mr. Justice Brandeis stated that "every important determination by the court in receivership calls for an informed independent judgment" (46, p. 436). The valuation precedent existed in law, but was not clearly enunciated or uniformly applied.

Requirements under the absolute priority rule

The Consolidated Rock Products case established the responsibility of a district judge to make a finding of value by the earning power criterion in order to reorganize a corporation in accordance with the absolute priority rule (3, p. 685).

Finding of solvency.- In the Consolidated Rock Products case, it was held that the value of the assets should be determined in order to furnish criteria for the apportionment of new securities between bondholders and stockholders in the event an equity remained for the latter. The future earning power of the company was held to be the proper criterion for a determination of the value of productive assets for the purpose of reorganization. Valuation for purposes such as taxation or ratemaking was not relevant, except to the extent that these might affect earning power.

Fairness and equity.- In order to establish fairness as between the several classes of creditors, the value of separate properties should be determined (3, p. 682).

Feasibility.- It was also held that a finding of feasibility, as well as fairness, is dependent on a determination of earning power, since it is not conceived that new securities should be issued unless

their interest and dividend requirements would be met from earnings.

Earning power defined.- In discussing the criterion of earning power, it was held:

> . . . since its application requires a prediction as to what will occur in the future, an estimate, as distinguished from mathematical certitude, is all that can be made. But that estimate must be based on an informed judgment which embraces all facts relevant to future earning capacity and hence to present worth, including, of course, the nature and condition of the properties, the past earnings record, and all circumstances which indicate whether or not that record is a reliable criterion of future performance. A sum of values based on physical factors and assigned to separate units of the property without regard to the earning capacity of the whole enterprise is plainly inadequate (3, p. 685).

Extent and method of investigation.- It was held that the extent and method of investigation used would depend on the circumstances in each case and the matter of a formal appraisal and the formulae to be used in distributing the new securities were to be left to the discretion of the courts. While the capitalization of prospective earnings method was suggested, it was not made a requirement by the wording of the case (3, p. 685).

Summary.- The Supreme Court required an earning power valuation, but left considerable leeway as to the exact methodology. The courts lacked the personnel and expert knowledge to make exhaustive investigations. The Securities and Exchange Commission was thus placed in a good position in its advisory role to influence the courts in the matter of valuation methodology.

The Securities and Exchange Commission Methodology

General

The Securities and Exchange Commission, with legal doctrine as a

guide, has developed a methodology for the valuation of Chapter X corporations.

Method of investigation.- The Commission receives much of the primary information on which valuation is based through the trustees and by examination of witnesses (36, pp. 64-65). It may also expand its investigations to outside sources, such as trade associations, government agencies, and persons having special knowledge of the industry. In some cases, the Commission has utilized the special reports of engineers and other experts employed by the trustees and other interested parties to provide the basic material and approach on which the Commission has based its own estimates, e.g., Minnesota and Ontario Paper Company (4:7;481-483).

Annual Reports.- The Annual Reports of the S.E.C. are of little use in the examination of valuation procedure. The Commission tends to mention briefly a technique or a standard in its annual report in the year it first becomes important, but has not published a set of exact principles.

Advisory Reports.- In order to determine the methodology of valuation used by the Commission it is necessary to turn for the most part to the Advisory Reports (4). In this connection, it should be noted that the cases included therein are only those in which there is a substantial public interest. Full reports are made for verbal presentation by the Commission in other cases, but remain as S.E.C. internal reports. The Federal district courts are trial courts and these cases are not included in the law reporting services. Some of the information included in an internal advisory report may be reported in an appealed case, but this information is likely to be only that germane to the judge's opinion.

Three general classes of valuation problems

The Commission faces three general classes of valuation problems. These are immediate liquidation, liquidation over a period of time, and assumed perpetual or indefinite economic life.

Immediate liquidation.- Nonoperating assets, which would not impair earnings if disposed of, are valued separately and on a liquidating basis. Also, if the entire properties are worth more in liquidation than as a going concern, the enterprise should be liquidated. The S.E.C. approved a liquidating plan in the Porto Rican American Tobacco Company case (4:7;303). Both nonoperating and operating assets were appraised on a liquidating basis. The total liquidation value substantially exceeded the going concern value (4:7;308-313).

Immediate liquidation valuation may be relatively simple if there are no earnings or if it is clear that the property is not needed in the business. Separate departments may have to be valued on an earnings basis to determine whether or not they are worth more in liquidation. In the McKesson & Robbins case, it was decided that the liquor department was worth more in liquidation than for the company to operate it, although it was to continue operating as long as it did not become unprofitable (4:8;858). In almost every case, excess working capital, which builds up while interest and certain other costs are stopped during the proceedings, will be valued separately at its cash value. Any case where there is an offer to purchase the property for more than its going concern value will be in the immediate liquidation category, e.g., Texas Portland Cement Company (4:40;1084).

Liquidation over time.- Orderly liquidation over a span of time

under a plan of reorganization, rather than a forced sale, allows the distribution of greater value and still observes the priorities of contractual rights. In the Ulen & Company case, the trustee's plan had as its sole objective the liquidation of the assets for the benefit of the creditors (4:9;579). Ulen Realization Corporation was to be formed for that purpose. In the case of Reynolds Investing Company, Incorporated, debentures were allowed to remain in the capital structure with a provision for their very early maturation, and with very restrictive provisions on management governing their voting rights (47, pp. 1-2).

In the Rocky Mountain Fuel Company case, the Commission stated that the valuations placed on the properties were "essentially liquidation values" (4:20;28). Since the company's operations as a coal producer were soon to end, going concern or reorganization valuation by capitalization of earnings could not be made, so a new realization corporation emerged in order to conduct an orderly liquidation. Other cases involving depleting assets are unique and will be treated at other points.

The Silesian-American Corporation case was a highly complicated situation involving international holdings during World War II in Poland, Germany, and Switzerland (4:31;1-4). There was no way to determine the value of the Polish government obligations or whether it would pay them, nor to determine the value of any settlement with the German government. The Commission stated that it was in agreement with the trustee's "apparent conclusion of insolvency for reorganization purposes" (4:31;40). Because of the nature of the assets, the Commission did not believe it was possible to evaluate them for reorganization purposes.

In cases of investment companies or their equivalent, the

portfolio assets are usually valued on a market price basis. The Central States Electric Corporation was a public utility holding company registered as "a closed-end, non-diversified management company" (4:30; 681). It was proposed to value the portfolio assets on the basis of the average of their closing market prices for the twelve Fridays preceeding the effective date of the plan, but this was opposed. The Commission felt that debenture holders who were to receive common stock would be forced to speculate on their participation prior to the effective date of the plan (4:30;711). In the Supplementary Report on the amendments, the method for determining the value of the portfolio assets was amended to provide that the computation would be made by averaging the closing market prices on the five business days immediately preceeding the effective date of the plan (4:31;395).

Other cases of liquidation over time include most of the street railway and urban real estate companies on which Chapter X Advisory Reports were rendered, such as the Pittsburgh Railways (4:31;432). Such cases may or may not involve inequities to security holders; however, they are not the subject of this dissertation. They are presented herein to a limited extent due to their bearing on the general valuation procedure. Such cases may involve unique public policy or economic valuation considerations not to be found in industrial cases.

Perpetual or indefinite economic life assumed.- An appropriate capitalization of reasonably expected earnings is the principal method applied by the Commission to operating assets when there is a record of earnings. If the assets are not of a depleting nature, perpetual life is assumed. Even if it is clear that the future for the company may be very risky, perpetual life or its equivalent, indefinite life, may be

assumed. The Commission has legal cases and financial writers as its authority for earning power valuation by the capitalization of earnings method (49, p. 11). Details of this are to be found herein under Critique of the Commission's Methodology, Valuation in the industrial field. Reproduction cost (48, p. 8), book values (49, p. 11), and original cost (50, p. 18), were rejected in early cases as inappropriate for Chapter X reorganizations, unless having a bearing on earning power.

An apparent exception to these principles occured in the case of the National Radiator Corporation (4:4;690). The company could not be valued on the basis of its earnings record. While admitting the danger of valuing property on some other basis when not supported by an earnings record, the Commission took the reproduction cost new less depreciation of the fixed assets, "taking into account their present condition and utility," and added the book value of all the remaining assets to reach a figure of approximately $6,000,000 (4:4;695). The figure of $2,950,000 for the fixed assets was regarded as a maximum value. Since the company was clearly insolvent, there was no need for an earning power valuation. The Commission stated that the possibility of profitable operations was not demonstrated. Such a valuation is obviously possible for the purpose of demonstrating insolvency when little or no earning power exists.

A finding of total enterprise value by itself may not be sufficient to determine fairness. Whenever there are both secured and free assets and there are both lienholders and unsecured creditors, the question of allocation of value may arise. In general, when a deficiency exists in the satisfaction of lienholders through the valuation of the property covered by their liens, it will be necessary for such

lienholders to share in the unmortgaged assets on a parity with the unsecured creditors. In the Minnesota and Ontario case, the Commission made valuations of separate groups of properties adequate to make the necessary allocations of value as between mortgaged and free assets (50, pp. 58-69). This may involve different rates of capitalization for the separate properties to be allocated.

Conclusions.- Valuation is an intricate matter involving numerous variables in some cases. Some overlap in valuation problems exists between the three general classes. For example, properties with limited life may be valued on a realization basis if insolvent, but may be valued much as a going concern if earnings may be estimated and the firm is more valuable than if liquidated immediately. While the capitalization of earnings under the assumption of perpetuity is relatively simple, earning power valuation of properties with limited future life is dependent on a minimum of three principal elements. These are the amounts of earnings, the future period over which they may be expected to continue, and the rate of interest or discount. Both the cost of improvements and maintenance and the probable scrap value must be considered as well. Such cases are among the more intricate faced by the Commission. Hence, much of the discussion which follows, under the headings of Estimate of Earnings, Rate of Capitalization, Depreciation, and Depletion, applies to these cases, as well as to those which assume an indefinite future life.

Estimate of earnings

In order to use the earning power criterion in applying the absolute priority rule, an attempt is made by the S.E.C. to estimate earnings in all cases in which it is possible to do so. However, in the

Pittsburgh Railways reorganization, the Commission stated that "an estimate of prospective earnings obviously is not something which can be arrived at with mathematical precision and certainty. An informed judgment is the most that can be achieved . . ." (4:31;439).

The S.E.C. has taken the position that the "debtor's past record of earnings, adjusted or weighted to give account to unusual past conditions and reasonably foreseeable changes, provides a guide to a determination of earnings reasonably to be anticipated in the future (4:7; 181). This statement poses two related problems: (1) the past period of earnings which will be used as the basis for the estimate of future earnings, (2) quantitative adjustments to that record. After these adjustments, it will be necessary to decide how much weight the past record will be given in determining the estimate of the future level of earnings.

Past earnings.- A sizeable group of cases seem to emphasize past earnings as the best guide to the future level of earnings. In other cases, the past record provides few clues to the future earnings. When the past record of earnings is the guide, no mechanistic formula is used. In fact, qualitative factors seem to carry as much weight as the actual figures themselves. There is a strong tendency to utilize some period of time that will fit the economic logic of each case. In the Atlas Pipeline case, the S.E.C. accepted as a base period the earnings of five months, November, 1940 through March 1941 (51,pp. 16-17). It was said that there were extenuating circumstances related to the earnings of the two previous years, 1939 and 1940.

In the case of Flour Mills of America, the Commission utilized the earnings for two non-consecutive years which were not strongly

affected by the company's speculation in grain (4:7;10-12). The early history was rejected because the nature of the company's business had changed. In the case of the Griess-Pfleger Tanning Company, the Commission used the most recent year, but estimated the last six months (52, p. 7).

A survey in 1941 showed that of fourteen cases in which the period utilized had been given by the S.E.C., eight of the cases used a period of one year or less (53, p. 130). In three cases, periods of three to four years were considered, while in the other three cases, earnings of five to six years were considered. It was concluded that the S.E.C. was inclined to eliminate rather than adjust abnormal years. In most cases, the Commission has gone to great lengths to explain its reasons for adopting the particular period of earnings. In the case of Sayre & Fisher Brick Company, the earnings of the single year 1940 were chosen. Earnings were said to be above the five preceeding depression years, but far below the highs of the last boom period (4:10;69-70). Because of changes in the nature of the company's market, trends in the construction industry, and capacity in the brick industry in relation to residential construction, the year 1940 was established as normal (4: 10;68-71).

Quantitative adjustments in earnings fall roughly into two classes. First, the adjustment of past earnings is designed primarily to eliminate those past years which are considered atypical of the past, and, second, to select earnings which may be typical of the future. For these reasons, the Commission has inquired rather deeply into selling and advertising expenses, profit margin trends, the sources of unusual sales, non-recurring income or expenses, and other matters which would

have distorted the past record.

A special case in valuation of earnings exists in those cases in which losses before interest have accrued during some years. At the time of reorganization, the Deep Rock Oil Corporation had suffered large losses one year out of the five years chosen (48, p. 15). An adjusted five-year earnings average was used. In most of the cases either the years of losses were considered atypical or the corporation was considered to be of lower value as a going concern than in liquidation. In a few cases, the effect of a number of such years in the record seemed to cause the Commission to either lower the earnings estimate which would be derived from the average earnings or to raise the rate of capitalization of these earnings, or to make both these adjustments, e.g., Griess-Pfleger Tanning Company (52, pp. 7-8). The Commission tends to trim down past earnings provided by the trustee, e.g., Childs Company (54, pp. 6-7).

Future earnings.- The Commission has not been entirely consistent with respect to the possibility of economic change. For example, in the Minnesota and Ontario Paper Company, it considered favorably a probable boom in the market for insulation material (4:7;500-501). In several cases, increased profits from a potential war boom were rejected. In other cases, war boom profits were not rejected, especially if potentially large or already partially realized, e.g., Warner Sugar Corporation (55, p. 12).

The Commission apparently is able to dissolve some difficulty it might have with a forecast of earnings by making simplifying assumptions. In the Minnesota and Ontario Paper Company case, it assumed that sales and prices of newsprint would remain constant (4:7;488-489). In

another case, it was assumed that operations based on a temporarily "relatively stable hide market" were appropriate (52, p. 7).

Kinds of earnings estimates.- In some cases the Commission has utilized either past sales or past gross income as a guide to its estimate of earnings (4:7;181-190) (4:7;486-489) (4:8;864). In such cases, the estimate of operating expenses to be deducted is based on the company's actual experience. In the case of Childs Company (4:24;519), and of Keeshin Freight Lines, Incorporated (4:29;738), which had highly variable operating ratios, industry averages or "normal" operating profits were applied to the estimate of sales or of gross income. In these cases, the Commission assumed that these ratios could be attained after certain recommended internal changes were made. In other cases, the projected earnings were dependent on additional capital expenditures and on operation by some company or group other than the existing management, e.g., Texas Portland Cement Company (4:40;1086). Net operating income is the earnings estimate which the Commission capitalized in almost all early cases where property was valued on a going concern basis. Net operating income for this purpose is defined as the income from operations, after depreciation, but before interest and Federal income taxes.

Earnings trends.- Frequently, the Commission has been interested in reducing the company's activities rather than expanding them and has not been as optimistic about earnings prospects as were most witnesses. In the majority of cases, the Commission projected a constant future level of earnings. In cases of depleting assets, a declining level was usually forecast, e.g., Parker Petroleum Company, Incorporated (56, p. 16). In some cases failure of the reorganization to be

completed within a short time caused the Commission to have to take another look at its valuation. In the Penn Timber case, according to the third supplementary report, the record since the second supplementary report was reexamined due to an offer, from a group of owners of some of the first mortgage bonds and the unsecured claims and all of the unsecured notes, to form a new corporation to take over the old (4:17; 108). The Commission made no change in its original valuation, even though stumpage prices had risen substantially during the period. This was taken as temporary and it was said that in valuing large tracts "extreme highs and lows are usually disregarded" (4:17;112).

In some cases, the Commission projected an increased level of earnings, e.g., Green River Steel Corporation (4:37;519-522). In The Higbee Company case, the Commission rejected a rising earnings forecast based on the past record (4:8;789-790).

Summary.- The Commission's methods for estimating earnings, while seemingly sound, may yield inaccurate results. Because of its complicated nature, the earnings estimate will be further considered later in this chapter.

The rate of capitalization

General.- The Securities and Exchange Commission has stated its approach to the rate of capitalization only in general terms. Its statements have almost invariably centered on the importance of risk and uncertainty as establishing the rate. One of the more complete statements is given in the Minnesota and Ontario Paper case:

> The rate at which the earnings are to be capitalized must be predicted upon the risks inherent in the business and the degree of uncertainty that attaches to the continuation of the earnings. An estimate of the prospective earnings of a business enterprise, even though based on reasonable and appropriate

> premises, is subject to risk and uncertainty of realization. If the company has a long established record of profitable operations and if no materially adverse change in conditions is foreseeable, the degree of risk and uncertainty is reduced. Likewise, if the company has an established position in an industry in which cyclical fluctuations have not been severe or which gives evidence of marked future growth, the degree of uncertainty is minimized (50, pp. 33-34).

The position stated herein may be considered the Commission's position on the rate of capitalization, since the importance of the degree of risk and uncertainty in determining the rate is almost always stated.

Rates of capitalization used.- Surveys of the rates of capitalization used by the Commission in early years established certain patterns with respect to the Chapter X cases. According to Jome, when utilities are included, the rates allowed or recommended by the S.E.C. vary from about 4-1/2 per cent to 8 per cent for companies "with reasonably good prospects" to more than 12 per cent for "sick babies" (57, p. 633). For utilities, the rates have run from 4-1/2 or 5 per cent to 7 per cent, while for industrials the most frequent figures come within the range of 8 to 10 per cent, three reorganized companies being capitalized at 12 per cent or above. Professor Jome concluded that in some cases it was difficult to determine exactly what rate the S.E.C. recommended (57, p. 633, n. 19).

According to another survey of this period, the rate of capitalization for industrials tended to center on 10 per cent of net operating income (53, pp. 133-134). Net operating income is defined as the earnings after depreciation, but before interest and income tax. The lowest rate of capitalization, 8.7 per cent, was used for the McKesson & Robbins drug departments (58, p. 17). Of those companies of an

industrial nature whose rates of capitalization were clearly stated, 12 per cent was the most conservative figure during this period (59, p. 10) (60, p. 19). In most other cases of this period, earning assets were capitalized at 10 per cent, e.g., Deep Rock Oil Corporation (48, p. 15).

In later years, rates of capitalization were somewhat higher varying from 15 per cent before taxes in the Indiana Limestone Corporation case (4:18;492), to 15 per cent after taxes in the Keeshin Freight Lines case (4:29;738-739), when a 38 per cent tax rate was in effect. In early years, the rate was always applied to before-tax net operating income. In later years, the Commission has applied the rate to either before-tax or after-tax income, or it has calculated the rate both ways in individual cases. In the Childs Company case, the Commission applied a multiplier of 12-1/2 times to the after-tax income, equivalent to a multiplier of 8-1/3 times before taxes (4:24;520). This would be a rate of capitalization of 8 per cent after taxes and 12 per cent before taxes.

Summary.- Rates of capitalization were close in amount in early years, but varied more in later years. A shift away from emphasis on capitalization of before-tax earnings, also occurred.

Rate of discount

The rate of discount rather than the rate of capitalization is used by the Commission in cases in which limited economic life is assumed or in cases in which the firm's property consists primarily of wasting or depleting assets. The rate of discount is equivalent to the rate of capitalization except that in determining valuations of corporations with definite lives, the discount rate is applied to cash flow, i.e., earnings plus depreciation and depletion, whereas the

capitalization rate is applied to earnings only in evaluating corporations with indefinite lives. This is entirely valid, since in the former cases it is not intended to replace the property.

Rates of discount used.- In some early cases, rates of discount were as low as 8 per cent, e.g., San Francisco Bay Toll-Bridge Company (61, p. 3). Rates were also as high as the 15 per cent recommended as appropriate in the Atlas Pipeline case (51, p. 24). However, in that case, the cash flow from current assets to be liquidated over time was discounted at 6 per cent. The Commission valued the assets both as to the present value of the future liquidation values and as to the discounted present value of earnings of an asset with limited life (51, pp. 23-27). The S.E.C. estimated the economic life of the company at five years for the purpose of valuation, but said that the value would not be changed materially, if it were three years, or even seven or eight years. The Commission said:

> This is explained, briefly, by the fact that as the assumed operating life is extended, the present worth of future earnings is increased. However, at the same time the realization of the liquidating value of the assets is postponed and its present worth is correspondingly reduced. On the specific facts of this case these tendencies offset one another within fairly close limits (51, p. 25, n. 1).

However, the S.E.C. made a somewhat indefinite going concern valuation in the case, while actually recommending immediate liquidation.

A similar case which had elements of both liquidation and going concern valuation was that of the Philadelphia and Reading Coal and Iron Company. At the time, this company was the second largest producer of anthracite coal in the United States (62, p. 3). The iron companies were already in liquidation. Coal production and sales had been

declining for some time, and the Examiner "concluded that the Debtor's prospective earnings are so uncertain as to make it impossible to forecast earnings for a long period" and for that reason confined his estimates to the next five years (62, p. 19). The net gains from the assets were discounted at approximately 15 per cent.

Summary.- Rates of discount varied considerably as to kinds of property, but also between firms in the same industry. On the whole they were much lower than rates of capitalization, but they also contained the element of return of capital since they were applied to the income without deduction for depreciation.

Depreciation

One of the most critical items in evolving the true net operating income for purposes of valuation is the deduction for depreciation. A large error in this estimate may exclude or include some class unjustly.

Historical rate.- In the early period, the Commission did not overtly take the position that when assets were being valued on their new lower reorganization basis the charge for their depreciation should also be lowered. In most cases, the S.E.C. either considered past depreciation charges as correct or favored an amount close to the old figure. In the Minnesota and Ontario Paper Company reorganization, the Commission relied on a letter from Day and Zimmermann,* expressing the belief that it was "prudent practice to continue charging depreciation in a total amount not less than the recent total charges" (4:7;490-491).

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*Day and Zimmermann were consultants who conducted a study of the Debtor under authority of the Court.

In the Flour Mills of America case, it was stated that "the record provides no substantiation of the reasonableness of the annual depreciation charge of $45,000 assumed by the trustee, an amount $42,000 less than the average charge of $87,000 in the years 1936-1939" (4:7;17).

In the Griess-Pfleger case, the Commission questioned the small size of the depreciation estimated by the trustee ($30,000), which would have substantially increased the estimate of earnings (4:5;77).

Rates sufficient to maintain property.- In the Sayre & Fisher Brick case, the Commission reduced the amount of depreciation from $112,000 to $20,000 (59, p. 7). In this case, the allowance was for renewals and replacements necessary to preserve the present plant. While the old book value of the physical assets was not stated, it appears that the value was probably far too high on both an earning power and a liquidation basis. The producing assets consisted largely of some brick yards of substantial excess capacity and clay reserves with practically unlimited life (59, pp. 3,8). No depreciation would be taken on the land and it was not proposed to modernize the plant due to the type of brick produced. Even though perpetual life was assumed for valuation purposes, the case was much like a slow liquidation with respect to depreciation. Other cases of allowance only for necessary repairs and replacements were associated with liquidations over time.

Return of capital.- In some cases, indefinite or perpetual life possibly could have been assumed, but the cases were appraised as slow liquidations. In the Detroit International Bridge Company case, the depreciation reserve had been established at $225,000 annually, based on an expected life of 75 years (4:4;686). The Commission concluded that the total net income which could be anticipated was entirely inadequate

for such a charge, and that any dividend to be received was to be merely a return of capital. In order to achieve a feasible reorganization, the Commission ignored the ultimate fate of the bridge and limited depreciation or "similar allowances" to amounts necessary to replace parts as they were needed (4:4;686).

The principal of limited economic life is explained in a Chapter X real estate case (4:15;256). Due to its age, the economic life of the building was expected to be 20 years. In explaining that the useful earning life must be limited, it was said that "this does not mean that structurally the building will not last longer than 20 years or might not be useful longer" (4:15;265).

Summary.- In the case of companies with perpetual life or indefinite life assumed, depreciation charges are presently realistic, but are inherently subject to error with consequent impact on valuation results. In most cases, straight line depreciation is used. In cases of limited life assumed, depreciation is not deducted, but exceptions to this are found as to some portion of the assets.

Depletion

The method of estimating physical depletion is very important to the valuation of a firm with wasting assets.

Method of valuation of a firm with wasting assets.- The case of Parker Petroleum rather completely described the Commission's method of valuation of a firm with wasting assets (4:39;559-560). The future net cash receipts are to be discounted down to present worth. They consist of all revenues less all cash expenditures and ignore accruals for both depreciation and depletion. They embrace both current earnings and the return of capital. To them are added the discounted present value of

the estimated salvage values at the end of the expected life and the discounted present value of tax loss carry-over. Assets not needed in the business are valued separately. Where additional capital investments are required "the discounted value of such investments must be deducted from the total valuation to arrive at that portion applicable to the present investors" (4:39;560). In this case, the Commission used a 10 per cent rate of discount applied to the net cash receipts, as defined, after administrative overhead and estimated Federal income taxes (4:39;565).

Physical depletion.- Among the principal assets subject to physical depletion are oil and gas reserves. Here, as in cases of other natural resources, the Commission usually depends on industry or governmental sources for the depletion methodology. In the case of Parker Petroleum, the Commission accepted the "decline" method offered by a petroleum engineer employed for the purpose by the Trustee (4:39;560-563). Physical depletion of wasting assets is highly indicative of the rate of sales, or vice versa. If the total reserves are accurately estimated, the rate of sales or depletion may then determine the expected economic life and to some extent the physical life as well.

Federal income taxation

Total valuation will be different (depending on current tax levels) when before-tax and after-tax income are capitalized unless the rates of capitalization applied to each basis are exactly adjusted. In cases of firms with indefinite future life, the Commission prefers to capitalize before-tax earnings, but has stated the rates of capitalization both before and after taxes in most cases. However, in cases of firms with limited life, the Commission is forced to estimate the

after-tax income into the future on a year-by-year basis due to the method of valuation applying in these cases (56, pp. 15-16). Furthermore, the method takes into account the depletion allowance for tax purposes.

Conclusions.- The matter of Federal corporate income taxation is highly critical in regard to the earnings which are to be capitalized and the rate which is to be applied to them. The S.E.C. has used both the before-tax and after-tax earnings. By the use of before-tax earnings, the S.E.C. could be free from consideration of the level of taxation. This has an advantage in that it reduces the pressures on the part of junior security holders to maximize debt for the tax savings. However, in many cases the S.E.C. is forced to use the after-tax earnings as required by the method of valuation. The Commission is in an apparent dilemma with respect to the tax matter and has obviously used a rationale which seemed appropriate to each circumstance. Since the question of taxation is critical to valuation, it will be further examined in this chapter under Critique of the Commission's Methodology.

Securities and Exchange Commission findings of value

Within a few years after the Securities and Exchange Commission assumed its role in Chapter X reorganization, criticism by Harry G. Guthmann, and others, of the S.E.C.'s findings of value began to appear (63, pp. 739-754) (24, pp. 19-28). Calkins has pointed out that actual sales and net operating income, as well as the actual rates of capitalization later established by the market, varied considerably from the Commission's estimates within a five year period after the reorganizations were completed (24, pp. 24-26). The net operating income

estimated by the Commission was only 20 to 25 per cent of the amounts actually achieved by some corporations within five years after reorganization and such estimates were low in almost every case (24, p. 24).

Both the level of sales and of net operating income possess practical objections as tests of value for the period in question. The degree of price inflation which occurred during and immediately following World War II could hardly have been anticipated by the Commission, which proceeded on the assumption that the war sales were "boom sales." This idea was generally accepted at the time. The tendency to underestimate earnings, during the early years, could be attributed to World War II as well. This measure would reflect such items as curtailed service, more effective use of limited personnel, higher volume with the same facilities, and deferred maintanance, as well as little customer resistence to purchase.

Market value of securities outstanding.- Professor Calkins also presents strong evidence of probable undervaluation by the test of market value of securities outstanding (24, p. 23). All except one of the estimates of value made by the S.E.C. until that time, were low by this test. The price relatives of market value of securities outstanding varied from 75 per cent to 261 per cent of the S.E.C.'s estimate by 1946. This was taken as probable evidence of overcompensation of senior interests and undercompensation of junior interests when the latter were excluded from the plan by the valuation found under the absolute priority rule.

The market value of securities outstanding may be a fair test for the total valuation found for a year or two after the reorganization is completed. It normally requires at least this period for market

values of reorganization securities to stabilize. After this time, the changes in both the economy and the firm would make the market value of securities outstanding a poor test. The capital structure and total assets and consequently the earning power often change. Price inflation can affect security prices without an accompanying change in the real value of the assets. In the last analysis, the question of the period over which the test should be applied would probably arise, and this would be an insurmountable problem. Calkins has said of the market valuation of securities outstanding that "over a period of time it should approximate the valuation of the enterprise" (24, p. 23). It would be difficult to disprove the reorganization valuation found in the short-run, and many additional factors may appear over a long period. Finally, this test should be considered only after examination of the legal requirements and the technical aspects of the valuation procedure.

Market value of securities awarded.- Professor Calkins also mentions the subsequent market value of securities awarded by the courts as a possible test of the accuracy of the valuation (24, p. 21). Although the proper use of this test is more appropriately related to fairness and equity in the amount of the awards to the participating classes, there is a connection to valuation. If all participating classes were able to realize the full value of their claims through the sale of their securities, within a matter of several years, the possibility exists that some class or classes would be excluded by an inadequate valuation.

The market value of securities awarded in following years is the best test of full compensation in most reorganization settings. The legal position on market value of securities awarded is not stated in so

many words. According to former S.E.C. Commissioner Jerome Frank, the position taken by the Commission in Chapter X cases was that newly awarded securities "should be intrinsically sound, so that there is a reasonable prospect that they will have values equal to their face amounts, or in the case of stocks, equal to the values put upon them for reorganization purposes" (29, p. 340). Frank pointed out that the positions of neither the courts nor the Commission had been "rigidly defined" at the time (29, p. 341). It seems clear that the Chapter X reorganization courts need not guarantee present market value, although market value is in the background of the decisions.

The legal precedents for the market value test may be traced from the equity cases. Under equity reorganizations, new securities were awarded with "present value" somewhat equivalent to the value of the surrendered rights (22, pp. 147-148). Attention was on market value at the time of reorganization, although this value was not always achieved due to fluctuations during the proceedings.

The market value precedent tended to carry into Chapter X through the Los Angeles Lumber Products case (2). This case asked for an interpretation of the term "fair and equitable" and its applicability to Section 77B. As stated above, since the term was incorporated in Chapter X, the findings of the Los Angeles Lumber case applied to Chapter X. This case reaffirmed the absolute priority doctrine, under which the creditor is entitled to full compensation. Full compensation in reorganization is usually taken to mean payment of the full contractual principal and accrued interest in cash or new securities as though a liquidation were taking place. Despite certain difficulties in measurement, the new securities should be quantitatively and/or

qualitatively equal to the old. This will most often be intrinsic to the securities rather than being reflected in market values at any particular time. Yet, while the market value test may not be deliberately sought under Chapter X, it may enter the decision as to what and how much to award in some cases, particularly when the new securities under scrutiny are not of the best investment quality.

The foregoing analysis concerns the market value of securities awarded to each class of security holder. While the total of these values may approximately equal the market value of all securities outstanding for some time following reorganization, there is nothing in the precedent which says that they must do so. Further, discussion of full compensation is to be found in Chapter IV and of market and investment value in Chapter V.

The Commission's position on valuation.- The Commission has taken the position that it should not make valuations based on speculation as to the future. The S.E.C. has said that the "value of the assets must be determined at the present time and in view of presently ascertainable information" (60, p. 16, n. 49). The Commission cites the case of the Reading Hotel Corporation as its authority (64). By its wording in all cases, the S.E.C. indicates that it is concerned only with value at the time of its advisory reports. In addition, a requirement to find a valuation only at the time of reorganization may be inferred from the Commission's charge to render an advisory report when requested by the court. This value may be overridden by the court, but this has seldom been done to any extent to this time.

In those plans of reorganization which the Commission, or the courts, disapprove as to valuation or for other reasons of fairness and

equity and of feasibility, new findings of value must be made at later dates, e.g., Childs Company (65, p. 4). Usually, a new valuation is also required when a new plan of reorganization is proposed while the corporation is undergoing liquidation over time, e.g., Penn Timber Company (4:4;630) (4:17;107).

Date of confirmation as a bar.- The date of confirmation is usually considered to be a bar to a new finding of value. However, between the confirmation and final decree, according to Luby, one of the parties at interest may request a modification of the plan of reorganization (66, p. 265). Such modifications may include a request that the company not be liquidated, but rather that it continue operations to achieve greater value. According to Luby, although courts have authority under the statutes to modify plans, both before and after confirmation, "they generally hold that the confirmation order fixes all rights" (66, p. 266). The court may reserve jurisdiction for later modification over only part of the plan.

Appeals.- Appeals may be taken alleging unfair treatment under a plan of reorganization. In an appeal growing out of The Higbee Company reorganization, certiorari was granted because of its importance to the matter of corporate reorganization (67). Two preferred stockholders, Potts and Boag, had sold their stock and their rights in an appeal to the claimants to the junior debt, Bradley and Murphy. It was held that the appeal of Potts and Boag was for the interest of all the stockholders and that when they "sold" the appeal, they sold something they did not own. The effect was to reduce the net value of assets held by the junior claimants, Bradley and Murphy, in favor of Potts and Boag by the amount of cash paid, whereas the statute contemplated any

reduction in value to junior claimants should go to senior claimants, the preferred stockholders as a class in this case (67, p. 212).

The case brought out that Potts and Boag had appealed under Section 206 of the Chandler Act, which gives any creditor or stockholder "the right to be heard on all matters relating to corporate reorganizations" (67, p. 210). The opinion also said that the district courts have jurisdiction to "exercise all equitable powers unless prohibited by the Bankruptcy Act" and furthermore that Section 222 gives the judge the power to "alter and modify a reorganization plan even after confirmation"(67, p. 214).

Allowances for error.- The S.E.C.'s valuation is predicated on the completion of the proceedings by a certain date. The junior interests have the right to bid for the purchase of the company through a proposal and may delay the proceedings by legal delaying tactics, so that a new valuation is forthcoming. But the Commission seldom changes the original earning power valuation substantially.

Before the absolute priority rule was strictly enforced, long term warrants were often approved, but in later cases the Commission has taken a strong stand against the approval of such warrants (68, pp. 2-8). In the Childs Company case, it was said, "we believe that the issuance of long-term option warrants constitute an unsound financial device . . ." (4:24;120). Very short term warrants have been approved under some circumstances in recent years (56, p. 8). When long term warrants are not approved, for all practical purposes, no allowance for error in valuation exists.

Summary.- The Commission seems to be supported by the law in its requirement that value at the time of reorganization is all that is

needed. In addition, the legal positions seem to support the Commission in its requirement that only reasonably foreseeable changes need be predicted. However, the possibility that the Commission should allow for error is not to be found in the cases, but rather in the Commission's reasoning.

Critique of the Commission's Methodology

The valuation found

In practically all cases, the Commission has rendered advisory reports based on a single best estimate of value. In some cases, it has placed this value within a range (69, p. 20). However, the range is very limited and is usually related to some uncertainty as to the amount of current assets which might exist on the date the plan is to be confirmed. Other uncertainties, such as the probable outcome of suits, may or may not enter directly into the valuation (65, pp. 4-5) (70, p. 13).

These uncertainties often affected the value of the award to the residual claimants rather than the going concern valuation, but still left an area of doubt as to the total enterprise value. However, in every case there will be some uncertainty as to the expenses of reorganization. The Commission has admitted, in one case, that there may be a "considerable range of reasonable estimate" within which the single valuation figure may fall (71, pp. 17-18). Yet the Commission states, in many cases, that the specific valuation it finds is a maximum value. From this terminology, it is difficult to determine in such cases whether the valuation figure is the upper limit of a range of possible values or is somewhere within the range of possible values.

This difficulty is compounded by the Commission's making tentative valuations adequate for the purpose of testing the fairness and equity and the feasibility of a plan of reorganization. In such cases, the valuation is said to be a maximum value. In the Penn Timber Company case, the Commission's valuation in 1940 was based on the maximum timber value (72, p. 5). In the Minnesota and Ontario Paper Company case, the overall valuation of $25,193,000 was said to be a maximum (4: 7;515). In these cases, the companies were insolvent and all the assets belonged to the mortgage holders. In such cases, a precise valuation is not needed and it is not necessary to complete the valuation procedure if it is obvious that the corporation is insolvent.

In those cases in which junior interests are included, the Commission made findings of value which gave the impression of exactness. However, in some cases the Commission's statements were qualified in some way. In the McKesson & Robbins case, it was said that the enterprise valuation of $76,900,000 was "a reasonable approximation based on adequate data" (4:8;857). In the Muntz TV case, valuation was found "in the neighborhood of $6,300,000" (70, p. 13). The Commission is prone to adjust various suggested elements of value to arrive at its own valuation. Impressions of exactness are given in the selection of data by the Commission. It implies that it is stretching value as far as possible toward the junior interests. The S.E.C. usually reduces the trustees' valuations. The major exception to this is when there is an offer by an outside group to purchase the entire enterprise (73, p. 3) (74, p. 1) (56, p. 1).

The Commission seems to attempt to protect the interest of the senior groups as opposed to the junior groups in internal reorganization

and all security holders at the expense of outside interests in the case of external reorganization, but this is not conclusive. In the Texas Portland Cement case, no future earnings estimate was made because the Commission thought that an internal reorganization was not possible (4:4;1084). The offer in hand from Alpha Portland Cement Company was greater than the capitalized earnings of the last two years, but was less than an independent estimate of the cost of reproduction. It appears that the Commission leaned toward an expeditious solution in this case, since the "valuation" found was the amount of the offer by Alpha Portland Cement, plus the cash on hand.

To summarize, the Commission either states or implies that its single best estimate is the maximum value that may be found. This approach must be inherently conservative, however, in order to assure that the absolute priority rule is not violated as to the senior interests. The approach tends to confuse the issue of valuation, since the best estimate should be within a range of maximum and minimum values. If a bias exists in this approach, it is suggested that means for allowing for the possibility of error be considered.

Valuation in the industrial field

Differences of opinion on valuation.- In different reorganization contexts, and for purposes other than reorganization, there has been considerable disagreement on what the method of determining value should be. In early public utility rate making cases, according to Bonbright, "replacement cost has generally been held to constitute the dominant 'element of value', although original cost is 'taken into account'" (26, p. 175). Replacement cost was also justified for taxation purposes. Valuation for both rate making and taxation are much changed

today, but are still subject to differences of opinion.

Montgomery B. Angell quotes from a statement on valuation made by Jerome Frank while Judge of the Court of Appeals for the Second Circuit, as follows: "The truth is that it has different meanings in different contexts, even in the restricted field of 'tax law'. And there, as almost always, 'value' involves a conjecture, a guess, a prediction, a prophesy" (75, p. 1). The Commission has paid little attention to valuation for other purposes, and has not used complex mathematical techniques to establish the maximum value of the firm, as suggested by the work of Massé (76, chap. 1).

In its general approach to valuation, the S.E.C. utilizes principles which are generally accepted with respect to the type of valuation problem involved and which appear to meet the general requisites of the law. In the early period, it made little attempt to develop principles, but rather urged on the courts the acceptance of techniques "which the appraiser has long considered sound," by using such techniques in its valuations (53, p. 129). In these early cases the Commission cited Bonbright (26, pp. 238, 875-881, 883-893), Dewing (77, p. 140), and Finletter (14, pp. 499-502) (78, pp. 557, 567, 574) as its authorities on valuation. Bonbright said that "data, such as the original costs . . . replacement costs, or current market prices of outstanding security issues, have no significance whatever, save as a clue to the earnings that may fairly be capitalized" (26, p. 238).

The lower courts, in early rate-making and other types of reorganization cases, were inclined to be strongly influenced by the skill of the attorneys toward many special considerations other than earning power valuation. According to Calkins, the use of book values,

reproduction costs and "other accounting methods" were largely responsible for violations of the observance of strict priority of liens (79, p. 18). The Commission has given consideration to book or reproduction costs, but only because of their bearing on possible future earnings.

In the San Francisco Bay Toll-Bridge case, where the earning power was very poor, no allowance was made for any value of assets which might remain after the franchise expired, nor would the Commission permit a value for the franchise itself or for the use of depreciated book values as a basis for valuation (4:6;874,nn.22,24).

Going concern valuation by the prospective earnings standard was stated to be "generally accepted both by authorities in the field of finance and by the courts . . ." (49, p. 11). The Commission pointed out that it had "consistently applied this standard of measurement of value" in both public utility and industrial reorganizations (49, p. 11, n. 14).

The principle that the value of assets should "be based primarily on the reasonably prospective earnings derivable from the utilization of those assets" was mentioned in the Minnesota and Ontario Paper Company case (50, p. 18). The Commission refers to the "leading writers in the field of law and finance," again by mentioning Bonbright, Dewing, and Finletter, but also cites certain legal cases (80) (81). In the case of Temmer v. Denver Tramway Company, the court rejected valuation for rate-making purposes as being an improper criterion of value for the purpose of finding an equity in a reorganized corporation. The court stated that "practically speaking and in the light of human motives, and experience, exchange, or actual value of any commodity, except jewels, works of art, fungibles, and the like, is

bottomed on what a property will produce in earnings to the owner" (80, p. 229).

Since Bonbright and Finletter were mentioned as authorities on valuation in the Consolidated Rock Products Company case, it can be assumed that the Commission is on good legal ground in using their general views on valuation (3). The faithfulness with which the principles are applied, some of the practical aspects of application, and divergent views on some valuation factors require further examination. Most Chapter X cases involve a rejection of one or more valuation factors suggested by people in the affected industry, but it is also clear that the Commission adopted some techniques directly from the industry.

Extreme fluctuations in value.- Aside from the widespread differences of opinion on value in the industrial field which may be explained in part by the divergent motives of the various interests, the question of whether or not a valuation may be made with accuracy, in any event, has been raised (63, pp. 739-754). Professor Guthmann was concerned with at least two related matters which have a bearing at this point. He asserted that value of property, and particularly of income-producing property, is subject to extreme fluctuations (63, p. 746). Related to this is the fact that the "uncertainties of reorganization" and the attendant costs are factors which reduce the present value of a company being reorganized (63, pp. 746-747). He concluded that corporations might recover sharply from the depressed valuations found at the time of reorganization.

Professor Guthmann appears to have an attitude or philosophy, which is quite prevalent, to the effect that productive properties have a basic underlying economic value and unusual conditions will affect

this value only temporarily. This approach recognizes that the constant revaluation which occurs with respect to earning assets is made in an attempt to find the true long-term values, or "intrinsic" value to which Calkins refers (24, p. 23).

Depressed reorganization values.- Reorganization is most often justified under the heading of preservation of going concern value. This may be considered important, in a broad context, because of the potential loss of goods and services to the society, the loss of taxable property, and the loss of employment to the workers of a community. But most important, from a legal standpoint, is the preservation of property rights. At the time of reorganization, the property is depressed in going concern value, and during depressed periods, in liquidating value. If the former exceeds the latter, the corporation may be reorganized. If not, it may be liquidated and the proceeds of the sale distributed to the former creditors and owners, in order of priority.

Corporate reorganization involves the reduction of the total quantity of claims against the corporation to conform to its ability to support the remaining claims. The ability to earn income and pay investors determines the economic value of the firm. The actual economic value cannot be known with certainty; however, to properly effect a reorganization, this value must be estimated, either as a specific amount or as a range. If a specific finding is made, later events may prove it incorrect. Selection of a range of value would introduce difficulties related to the actual amount of securities to be issued and could still prove to be incorrect. However, it seems clear that the reorganization value should be based on the future ability to pay creditors and owners.

The effect of a much lower value in reorganization than that indicated by the previous face amounts of securities will usually mean the exclusion of one or more of the former interests in the corporation. Under the absolute priority rule, this is a necessary characteristic of reorganization. The distribution of the new securities has been a matter of contention between interested parties and the courts for many years. Almost from the beginning of its existence, the Securities and Exchange Commission has been required to observe the absolute priority doctrine in industrial reorganizations. Under the law, this requires a valuation. The notion that a valuation cannot be made must be summarily disposed of. However, it is entirely possible that serious errors in valuation may be made.

The number of variables

Increased possibility of error.- The large number of variables with which the S.E.C. deals in valuation of industrial corporations has undoubtedly contributed to the possibility of error. A number of these have been mentioned in connection with the Commission's procedures on valuation. The material presented does not reveal the extent to which detailed analysis of company and industry operations are made. Each of these small variables are subject to error in estimation.

Offsetting errors.- Theoretically, the less important variables have little impact on the total valuation. This is especially true since the errors may be expected to partly offset each other. However, if the Commission is deliberately conservative (or liberal) most of the errors may be in the same direction. Available data are inadequate to determine statistically whether the Commission is consistently high or low in its estimate, at the present time. According

to the conclusions of Calkins, in the early years of Chapter X, "Commission estimates of earning power in terms of operating income before interest and taxes have generally been low . . ." (24, p. 27). This would tend to overcompensate senior security holders at the expense of junior security holders. Calkins was also of the opinion that the selected rates of capitalization were low, as well, and consequently partly offset the low earnings estimates. The procedure used herein will be to examine only the main elements of value, the capitalization of the earnings expected from the operating assets and those deductions and additions which will affect these importantly. Since the earnings estimate and the rate of capitalization are the two most important elements in the S.E.C.'s valuations, they will be examined in detail. Large errors of estimate of these two variables in the same direction would produce excessive errors in the totals of the valuations.

Capitalization of earnings approach

The theoretical basis.- The theoretical basis for the capitalization of earnings method of valuation "has been supplied by the 'capital-value' school of economics" (26, p. 231). Under this theory, a capital asset can be worth no more nor less than the discounted value of the income received from it. It appears that the theory is essentially the same as the neo-classical theory of the investment and valuation of a firm (82, pp. 14-15). In its simplest form, assuming indefinite or perpetual life, the valuation is found by the capitalization formula $C = \frac{I}{r}$, where C is the capital value, I is the net annual income, and r is the rate of capitalization. With a known or estimated I, capital value will depend on the particular r which is chosen. Any r may be selected, depending on the requirements

or objectives of the individual and the environmental setting.

The income (I) is net income. If perpetual life is assumed, the gross income should be reduced by an appropriate charge for depreciation in order to replace the worn-out assets. According to Gordon, the neo-classical theory assumes perfect knowledge and freedom to lend and borrow at a given rate of interest (82, p. 14). Under these assumptions, investment would occur when it is possible to realize a higher rate of return than the cost of borrowing. This analysis opens up an entire area of inquiry which is not the subject of this dissertation. In the practical use of the capitalization theory it will suffice to say that capitalized value may change at some time in the future or may change immediately in the hands of some other investors. This is due to an actual or estimated change in income (I) or due to the use of some other rate (r) of capitalizing the given income by its recipient.

The principle of discounting is equivalent to the capitalization of income. Its use attempts to estimate the present value of all future years' income discounted from each of these years until the present. The present value of a single future year's income would be $C = \frac{I_n}{(1 + r)^n}$; where I is the annual income, r is the rate of discount, and n is the number of years into the future from which the income is expected. The value of all years for which income is expected is:

$$C = \sum_{i=1}^{n} \left(\frac{I_1}{(1+r)^I}\right) = \frac{I_1}{(1+r)^1} + \frac{I_2}{(1+r)^2} + \ldots + \frac{I_n}{(1+r)^n} .$$

Where both I and r are assumed to be constant over time, nearby years have a larger value than distant years due to a smaller denominator. Utilization of constant rates for both I and r yield considerably different

results, depending on the estimates for I and r, when the number of years over which the income is expected is of different magnitude.

The legal basis.- In applying the capitalization of earnings method, the S.E.C. has given very little legal justification and has used variable practices with little explanatory analysis or authoritative basis. In the early La France case, it said merely that it was "customary to use the device of capitalizing the earnings which may be reasonably anticipated" in order to convert earnings into a valuation (49, p. 11). In its initial annual report following the passage of Chapter X, the Commission stated that "in connection with the complex problem of determining value for the purposes described, the Commission shares the view of financial experts generally, and of most courts, that an appropriate capitalization of reasonably foreseeable earning power is the most reliable guide to value in reorganization cases" (83, p. 15).

Rather than establish authority for the capitalization procedure, the S.E.C. referred directly to Dewing as an authority on rates of capitalization (50, p. 33, n. 97). Mention of this failure on the part of the Commission is not meant to imply that there is not a legal or a theoretical basis for the capitalization principle or that the Commission has not explained its basis in other types of cases. Since Bonbright is the main authority for the earning power criterion, it could be assumed that the method he favored at the time was appropriate. Bonbright said that earning power was the proper test of value for determination of solvency under Section 77B, but believed that any generalization should be based on the cases. He stated:

There is a strict tendency, however, (a) to insist that the

> corporate properties shall be valued as a 'going concern' rather than at mere liquidation value, as long as liquidation is not contemplated, and (b) to measure value by the test of capitalized earnings, recent and prospective, rather than by historical costs, 'book values' of the assets, replacement costs ('physical value'), or market prices of outstanding securities (26, p. 885).

Bonbright concluded that methods based on costs or on a liberal capitalization of an optimistic earnings forecast would be indefensible under the absolute priority rule. He seemed to favor the capitalization of earnings method in reorganization valuation, but warned against the danger of neglect of other standards. According to Bonbright, both of the two principal elements, the "future earnings" and the rate of capitalization are subject to great difficulties of determination, especially the latter (26, pp. 265-266). "Future earnings" as such do not exist and "legally accepted rates of capitalization have been adopted by an admixture of tradition . . . and guesswork" (26, p. 266). He seemed to believe in the use of the method when required by the circumstances, especially the legal circumstances, but did not feel that investors, particularly in securities, should rely merely on the projected flow of income from some property (26, pp. 252-253).

Dewing, in discussing the capitalization of earnings method, states that while it is the only valid method available for the evaluation of a going concern, it is at best a "kind of sophisticated guesswork" (40, p. 287, n. 1). In the view of Angell, "the method of valuation by capitalizing anticipated earnings is simple in principle, but complicated in application" (75, p. 16). Other methods of evaluating earnings than a simple capitalization of the estimate are available (84, pp. 91-92). Both trend line and stock price methods are more appropriate for prices of common stocks and were rejected by Bonbright

(26, pp. 252-253), and Dewing (40, pp. 387-388), for the valuation of a corporation.

The earnings estimate.- The precedent legal cases have indicated that the past earnings have a bearing on the future earning power through their requirement that earning power be demonstrated. Under these precedents, the past record is merely one of "all the facts relevant to future earning capacity," and the past record may be rejected as "a reliable criterion of future performance" (3, p. 685). The S.E.C. apparently has taken this to mean that the past record must be the basis, unless it is believed to be no guide to the future. The Commission points out that the past record must be "adjusted" (48, p. 9).

The period selected.- The greatest adjustment made by the Commission is purposive selection of the past years whose earnings will be used as the basis for the estimate of future earnings. The most recent period seemed to be preferred by the S.E.C. as being most indicative of the level of future earnings. Often this was the most recent period of one year or less. In many of the cases on which advisory reports were published, the earnings used were for the years immediately prior to and including 1940 and 1941. In reorganizations concluded around this time, the most recent year was likely to produce the highest earnings, as well. This may seem inconsistent with the notion that the company will be undergoing reorganization at a time when its earnings are depressed. However, the earnings may have been depressed for some time prior to default, or the company may have entered reorganization some time before the advisory report was rendered, at which time economic recovery may have begun.

It may be more than coincidental that so much emphasis was placed on the latest year at a time when national income was rising rapidly. However, in later years, there is little evidence that the Commission tended to utilize longer periods of earnings or to deemphasize the recent period. Exceptions were found, such as the Warner Sugar Corporation case (4:17;355). In this case, the Commission said "we believe that it is appropriate to base an estimate of 'normal' earnings on the pre-boom period 1935-41 and to estimate separately the value of earnings during the remainder of the war-boom period" (4:17; 364).

In the Keeshin Freight Lines case, the estimate was based on the years 1941, 1947, and 1948, which had been favorable (4:29;734). But in the case of Muntz TV, Incorporated, the Commission stated that "because of the fact that the debtors' method of operation and merchandising is entirely different from that followed prior to the reorganization proceedings, an analysis of such past results is of limited benefit in estimating future earnings and valuation" (70, pp. 6-7). The Commission then made its projection by adjusting the estimates made in the testimony of two witnesses as to the probable rates of production and sales.

It is fairly clear that the Commission places a great amount of emphasis on the present levels of earnings, especially if they are improved. There is some basis in theory for utilizing the most recent year. Being close to the future in point of time, the most recent year may be most indicative of what the immediate future holds. Theory, however, would not allow giving the entire weight to the most recent year, if its selection is supposed to represent the entire future. This

would be particularly true for cyclical industries. The problem of evaluation of past earnings as a guide to the future is a notably difficult one, and the Commission has made an attempt to do this with the best techniques at hand, with some exceptions which will be discussed in the remainder of this section.

The earnings omitted.- The Commission's procedure often omits entire years from the recent past record. It would be appropriate to omit such years only if their earnings are not typical for some unusual reason which may be explained. In some cases the losses were directly related to unusual cost and income relationships in initial operations (73, pp. 2-3). In other cases the losses were due to consolidations and mergers with resultant overcapitalization at unpropitious times, e.g., Griess-Pfleger Tanning Company (4:5;72-73). In some cases losses were attributed to embezzlement (58, pp. 2-3), and to manipulation of securities (69, pp. 21-23). In other cases, losses were due primarily to a declining or depressed industry situation (62, pp. 3-4) (60, pp. 3-4) (59, p. 6). Other cases pinpointed unusual cost circumstances (85, p. 3), or specific errors of management, e.g., Childs Company (4: 24;89).

The omission of unusual costs, such as start-up or developmental costs, or of unusual income, such as sale of capital assets, is generally accepted procedure in the analysis of investments. The usual solution is the application of a high rate of capitalization to the average earnings of firms in cyclical industries, but the Commission has used various techniques.

The existence of years of large losses in the failure of firms in normally non-cyclical industries must be attributed to special causes

which may or may not be removed as a result of the reorganization. In the latter case, a satisfactory reorganization will not be accomplished, and the Commission has usually demonstrated this satisfactorily. When reorganization is recommended and past years are omitted, the Commission goes to great lengths to explain its reasons for making the omissions. These may include economic or business cycle reasons, e.g., Sayre & Fisher Brick Company (59, p. 6).

The earnings average.- On the matter of omission of earnings, the Commission is not consistent with its authorities. Dewing states that persons who show a willingness to buy entire industrial concerns "require that the earnings be averaged over a period of years in order to hazard a guess concerning actual, permanent earning capacity of the business" (40, p. 294). The rule does not apply to public utility firms, in which cases a single year's earnings are considered sufficient to indicate the level of future earnings.

However, Dewing has also presented evidence to show that the averaging of long-term earnings would be an erroneous procedure, unless these had been very stable (40, pp. 376-379). Yet, it is fairly clear that Dewing would prefer some average of past earnings as the basis for reorganization valuation, with two major exceptions. These are the effect of the management element on the overall valuation (40, pp. 283-286), and the use of a unit basis (40, pp. 295-296), such as gas meters in place or orange trees over eight years old. Such rule-of-thumb methods would be used only when it was generally understood that they had a good basis for producing a given quantity of earnings and when they would be adjusted by the bargaining process. Actually, the Consolidated Rock Products case rejects a "sum of values based on physical

factors" without an earning power valuation of the entire enterprise (3, p. 685).

Past earnings and future earnings.- Bonbright is of a contrary opinion to Dewing. He has said "the truth is that, when earnings have once been 'realized', so that they can be expressed with some approach to accuracy in the company's accounts, they are already water under the mill and have no direct bearing on what the property in question is now worth" (26, p. 250). He also said that future earnings should govern valuation, but he recognized certain practical aspects of determination. Bonbright seemed to be convinced that there should be different methods of valuation for different purposes, over and above the legal requirements, and that reorganization valuation would be different than market valuation for investment in securities. With regard to the latter, he said "there is still an agreement among writers that a capitalization of average earnings over a period of 3 to 5 years (occasionally 10 to 15 years) is preferable, in most cases, to a capitalization of the earnings of any single year"(26, p. 253). Nevertheless, he felt that the use of strict rules would be inappropriate. This would certainly be true, if the company operations or some external factor was considerably changed, as would be the situation in cases of economic failure.

Bonbright has said that when the courts allowed the past earnings as "admissible evidence," but disallowed the estimated future earnings, they were operating on the premise that the reported earnings were more reliable than those "presented by partisan witnesses" (26, p. 251). He concluded that the only way out of the dilemma would be a valuation based on future earnings "as estimated by skillful and

unbiased appraisers" (26, p. 251). He felt that tribunals selected from several public service commissions would meet this requirement.

The presumption that public service commissioners are unbiased is well taken, with some possible exceptions. First, at times a commission may desire to impress the public that it is doing its job by making findings against the interested party. Second, a commission may contain individuals or factions who use hearings as a forum for their points of view. Third, a commission may lean too far in one direction to accomplish what it sees as its primary objective.

Assumptions regarding earnings.- The criticism made herein is with respect to biases in the techniques, although attitudes may have affected the choice of techniques and the assumptions made. The S.E.C. used the earnings of the companies during the periods in which they were failing rather than probable future earnings, except in a few cases in which the past earnings were considered not to be a suitable guide to the future. Adjusted recent earnings were used in a number of cases in which perpetual life was assumed and an internal reorganization was deemed feasible, except for certain properties which were valued separately, e.g., Deep Rock Oil Corporation (48, pp. 15-17).

Aside from the purposive selection of years, the past selected earnings may be adjusted in a number of ways. The Commission typically adjusts the data on which projections are based for almost all the variables which would have a bearing on the valuation of earnings. It does not usually allow proposed figures to stand unless they are fully supported by evidence. This may, in itself, create a bias. The Commission usually assumes improved operations, and consequently reduction in costs, but not if these are largely intangible. It seldom approves

improved sales or income, if they are speculative.

Quite regularly, the Commission used an assumption that some variable would remain constant. It was used mostly with respect to such things as the prices of materials or final products, but also for tariff rates and competitive conditions. The Commission seems to use the technique as a means of showing that it has investigated all possibilities. The assumption that some condition will remain constant is a technique which was apparently borrowed from the economist or other social scientists. The S.E.C. states this much as the economist would state a simplifying assumption. However, the economist uses it in order to isolate a pair of variables. The Commission appears to use it to dissolve away any possibility that its calculations may not be correct. What it is saying is that the future will be like the recent past or the present. The technique can be considered to be defensible in valuation only if there is no information on which to make an estimate of the future.

The technique of "no change" has the advantage of holding constant the state of the economy. No case could be found in which the Commission predicted the state of the entire economy. Yet it made a number of predictions and assumptions related to economic matters as they would affect the particular industry. Under some of the circumstances, the use of the assumption of "no change" may have been as valid as predicting specific changes. It is not valid on a probability basis, if there is any information indicating a possible change in one direction. A possible technique to consider is to estimate the probability of the change and to give the effect of such change a partial weight based on the probability of its occurrence. There is little

evidence that the Commission used this technique.

An upward trend in earnings.- The S.E.C. appears to ignore an upward trend in future earnings, except to the extent it might recognize an upward trend through the level of earnings selected and/or through the rates of capitalization applied. However, it does recognize a probable declining trend. With this type of earnings record, or outlook, it either uses the discounted present value of future income or it recommends liquidation. When the outlook is favorable for earnings improvement, the capitalization of earnings method is favored. It is posited that when the trend of earnings is upward, the method is inaccurate. If the Commission must be conservative in its findings, to meet the requirements of the absolute priority rule, its estimate is probably the near-term average or the long-term minimum evaluation of the earnings as a component of its valuation. This method does not meet even the requirements of a straight line upward trend. A rising trend would require statistical treatment that could hardly be expected in this type of valuation problem.

The problem of projecting a rising trend was mentioned by Bonbright, who pointed out that indefinite percentage projection of an increase based on recent earnings improvement could reach astronomical proportions (26, p. 252). But he also showed that neglect of the trend of earnings could cause large differences in valuation within a short period. The objection to the use of trends in earnings seems to be that the courts are leery of any method which produces a result that cannot be demonstrated. However, the S.E.C. is in the position of having to determine future earnings to establish present value.

In some cases a rising trend may be too large to ignore. In

the Green River Steel Corporation case, the Commission used the entire earnings record as a means of forecasting a higher level of earnings (73, pp. 9, 12-13). During its three years of operations, the company had shown a rapidly rising trend in sales and net operating profit, but had losses before and after interest in its first year of operation, and losses after interest in its second year of operation. In its third year, net operating profit was $825,756. The projected level earnings of $2,100,000 was said to be attainable after "some period of time" (73, p. 15). In essence, the Commission selected an average level for the entire future.

In defense of the Commission, it should be noted that if an upward trend is slight, a liberal but level earnings estimate could produce comparable results to a year by year evaluation of earnings. The Commission may have made such adjustments in a number of cases, mostly through the technique of utilizing the best year or years in the recent past. However, in The Higbee Company case, past sales data were presented as index numbers and revealed that the sales had increased 80.1 per cent between 1933 and 1941 (69, p. 14). Profits from operations had also increased between 1936 and 1941 (69, p. 12). The management witness forecast a cumulative increase in sales of 2-1/2 per cent per year over the next eight years, and the "Special Master concurred with the witness in the opinion that this constitutes a conservative forecast" (69, p. 18, n. 17). The Commission, however, stated that such increase "appears to be an excessively optimistic forecast on which to predicate a valuation"(69, p. 18). Yet the S.E.C. said that there was "reason to believe that to some extent Higbee will be able to make further improvements in its competitive position" (69, p. 18).

The actual past sales were not given, but the S.E.C. based its valuation on the 1941 after-tax profit of $415,000. The sales and after-tax net profit which actually resulted are shown in the following table:

NET SALES AND AFTER-TAX PROFIT OF
THE HIGBEE COMPANY

Year	Net Sales	After-tax Net Profit**
1942	. . . . . *	$ 387,000.00
1943	. . . . . *	505,000.00
1944	$ 24,510,000.00	805,000.00
1945	26,075,000.00	945,000.00
1946	28,513,000.00	950,000.00
1947	37,651,000.00	2,206,000.00
1948	39,671,000.00	2,131,000.00
1949	41,997,000.00	2,400,000.00

Source: (86, p. 1751).

*Not available.

**After-tax earnings were adversely effected by the war time excess profit tax.

In this case, the Commission allowed a buffer to exist between its estimate and the probable future earnings. Such a procedure indicates that the Commission may be conservative in its earnings estimate. It seems almost certain that a high percentage of all approved reorganizations will be companies with an upward trend in earnings, but the Commission seldon recognizes this possibility. The S.E.C. may adjust these differences in growth of earnings through the rate of capitalization, but this method is also inaccurate for this purpose, as will be demonstrated.

When an upward earnings trend was strongly indicated, the Commission seemed prone to promptly point out the value of these extra earnings as a means of assuring early retirement of notes and other debt strengthening the quality of junior securities of inferior position in regard to dividends (69, p. 24). In short, if the possibility of an upward trend was admitted its meaning was related to the feasibility of the plan rather than the total future value of the firm. In such cases, the probability of earnings of future years dropping below the selected earnings would be vastly less. This would increase the Commission's ability to observe the absolute priority rule as to the senior securities, when using the subsequent market value of securities awarded test. It is posited that the S.E.C. is under an obligation to find a specific valuation in all cases in which reorganizations are predicated on that valuation, and that such valuation must take into account all expected future earnings. This requirement may be modified to the extent that only the relevant future need be predicted, but the irrelevant future should be the distant future rather than the near-term.

Suggested change in technique.- A satisfactory solution to the problem of rising or variable income is suggested by the method used by the S.E.C. in the Warner Sugar Corporation case (4:17;364-365). The Commission considered the probable substantial war and early postwar profits, which were relatively very high and proximate and could not be ignored. It was noted that sugar production quotas had been suspended and that the current price of sugar was historically high. It was decided to value these earnings separately at approximately the average of their present value.

Normal earnings before depreciation and certain general and

administrative expenses were $300,000. Net operating income of $170,000 was capitalized at 10 per cent to produce a valuation of $1,700,000. War boom earnings of $1,200,000 in 1942, $300,000 in 1943 (affected by submarine sinkings), and $900,000 in 1944 were estimated to continue for at least two years after the war at the rate of $700,000 per year. The Commission observed that it would require only 2-1/2 years from 1944, undiscounted, to earn an amount which, when added to the pre-boom "normal" earnings, would equal the value of $3,000,000 required by the plan for the assets to be retained (4:17;365). The large size and relative certainty of the war and immediate post-war earnings contributed vastly to the valuation, which must be judged quite conservative.

This writer suggests that in cases in which highly variable or rising future income is indicated, the Commission should make its estimates on a year to year basis for the foreseeable future and discount these years down to present value at an appropriate rate of discount. The remaining value at the end of the foreseeable period may then be estimated, based on a level rate of earnings. These could possibly be the average of the near-term projection, but would have a higher rate of discount applied to them. If it were desired that a single rate of discount be applied, the earnings could be projected a considerable distance based on the long-term past record of earnings and adjusted after study of relevant economic factors.

Kinds of earnings estimates.- Various kinds of earnings estimates are possible and some of these have been discussed. From gross operating income may be deducted three main elements, (1) depreciation or depletion, (2) Federal taxes, (3) bond interest. It is possible, also, to determine earnings on common equity only. The two principal

elements which the Commission deducts to determine the income which will be capitalized are depreciation and Federal income taxes. The amount of the remaining earnings is termed net operating profit.

Depreciation.- In every case of assumed perpetual life, the Commission made a deduction for depreciation. However, in some early cases the depreciation charge was either questioned or changed. The Commission seemed to lean toward the old rates, despite the fact that some properties were definitely overcapitalized due to mergers (4:4; 690). The proper charge for depreciation under various circumstances is a highly controversial subject. The main choices seem to be between original cost and replacement cost as to base and between declining balance and straight line methods as to rate (87, pp. 42-49). In the early Chapter X cases, the pressures were strong to keep the old base for income tax purposes (61, p. 5). Section 270 of the Bankruptcy Act provides that the tax base for the debtor's property in the hands of the reorganized company shall be reduced by the amount by which indebtedness of the debtor had been cancelled by the Chapter X proceedings (1:52;710). The principle effect of this was that plans of reorganization were proposed which were designed to minimize the tax effect on both the corporate and the individual taxpayer. Vastly reduced securities representing vastly reduced valuations would eliminate the company's tax base, so that it would be unable to charge depreciation on future tax returns. In addition, in case of sale of the property, the entire proceeds would be taxed as a capital gain.

In the San Francisco Bay Toll-Bridge case, the S.E.C. stated that an effort was not made by the bondholders to obtain a suitable tax base because of the possible effect on the tax liability of individual

bondholders. The Commission stated, however, that the consequences to bondholders as a group should prevail (4:6;881). Amendments to the Bankruptcy Act, passed in 1940, were designed to meet "this precise type of situation" (61, p. 5). According to Darrell, the continuity of interest doctrine as related to bankruptcy, receivership, and foreclosure was clarified by the Supreme Court in a long series of decisions from around 1939 through 1947 (88, p. 14). This separate area of inquiry is highly complicated and is well outside the scope of this dissertation.

Under the Internal Revenue Code, the sales price is generally taken as the new valuation for tax purposes for old assets in the hands of a new purchaser. One may select the method of depreciation from among several alternatives. Exceptions include certain industrial equipment and aged assets which have specific rates of depreciation as established by the Bureau of Internal Revenue.

This writer suggests that failure to make the correct estimate for depreciation would make little difference in the flow of funds, but can make a large difference in the estimate of earnings that are to be capitalized. The Commission should make clear the basis for the depreciation charge when it approves a valuation based on assumed perpetual life. A conservative (high) charge would produce a lower valuation, but would be difficult to justify under the straight line method which is clearly indicated by the capitalization of earnings method.

Depletion.- In cases of depleting assets, the discounted net cash gains are properly used by the S.E.C. as the principal valuation factor. The precedent legal cases do not distinguish between the rate of capitalization and the rate of discount, and the theoretical basis

for them is the same. Another class of cases in which the S.E.C. appropriately used the discounting method was that in which the income was assumed to terminate after a specific number of years. Each of these two classes of cases assumed a return of capital which is equivalent to depletion. Net cash gains could be considered to be the return of capital, plus or minus a return on capital.

In cases of recovery of capital for a firm with limited life, a different, but equivalent, approach may be taken, in that depreciation is charged against the income, but the income from the depreciation fund is also calculated. This will provide a much lower present value of assets which difference is offset by the present value of the depreciation fund. Such attention to accounting conventions would be unnecessary and would only complicate the calculation when it is not contemplated that the assets will be replaced. In some cases of companies with limited life assumed, the Commission used the earnings after depreciation. The use of this technique would reduce the net income to be capitalized. Such a procedure might be justified if part of the property were to be replaced periodically in order to maintain earning power, but this was not stated in the cases. The Commission assumed either that the property would be abandoned or have only scrap value at the end of the period, or it ignored the ultimate fate of the property. The latter course could properly be taken only if capital value were entirely deficient as to the first mortgage bondholders at the time of reorganization. Properly discounted salvage value should be considered if depreciation is taken. If such value is not likely, the Commission should provide that only maintenance, necessary to retain earning power, be carried out. These costs may be deducted as incurred as operating

expenses for purposes of valuation, after their probable level is established by the Commission.

The rate of physical depletion may be considered a critical point in the determination of the value of a wasting asset. Once an estimate of the amount of the reserves is made, the rate of depletion theoretically would establish the remaining life. However, this amount will vary with the state of the industry, the state of technology, and the state of the economy. The Commission was forced to struggle with this problem in several cases when the reorganizations were not completed promptly. The rate of physical depletion, when taken with the expected sales prices, is highly indicative of the annual income and, consequently, the valuation of firms with limited life.

Federal corporate income taxation.- In early reorganizations when indefinite future life was assumed, the Commission used the before Federal corporate income tax net operating income as the earnings to be capitalized, but usually showed the after-tax rates of capitalization and earnings, as well. As tax rates change over time, the effect of stating a rate of capitalization for both before-tax and after-tax earnings is to have two separate standards, both applied simultaneously. In some later cases, after-tax income only was capitalized (70, pp. 12-13) (89, p. 10). In each case of limited life and depleting assets, and in cases in which tax liability is different from the rate in effect, it is necessary that the after-tax income only be considered.

It is suggested that the after-tax income should be the only standard used for reorganization valuation. According to Dewing's The Financial Policy of Corporations, upon which the Commission has relied for its rates of capitalization, the income to be capitalized is

apparently always after-tax income, although Dewing does not state this directly. In one instance, he says that a 10 per cent basis means that "the value is about 10 times the net earnings" (40, p. 292, n. s). In another instance, in reporting a 32-year study of five companies, net earnings are defined as "after depreciation reserves, taxes, but before bond interest or preferred stock dividends" (40, p. 377). In setting specific percentages standards as to the degree of risk, the reference is always to "net earnings" (40, pp. 390-391). Use of the before-tax basis implies that the present and future level of taxation has no effect on the present and future value of the firm. Future income can properly be estimated only after consideration of the present level of taxation and probable future changes in the level. However, attention is seldom given to the differences in the tax rate from one period to another.

Taxation, as such, is of greater importance than its rates. The Commission has been confronted with attempts to maximize debt in the reorganized corporation to gain the benefit of the tax-exempt nature of debt (89, p. 10). These considerations are of such importance to the major thesis that further discussion will be reserved for Chapter V. However, it should be pointed out here that in order to determine the probable tax liability, the S.E.C. is in the dubious position of determining the amount of debt and its probable interest rates before it determines the total valuation. This approach departs the normal order of accounting for income, and violates the principle of asset coverage for debt securities. The S.E.C. could not accurately determine the probable amount of debt and its cost to the company without having a preconceived notion of the actual valuation it will find.

After determining the amount of debt, it may then adjust the remaining earnings to the preconceived valuation through the rate of capitalization chosen.

A method of segmenting value and its earnings requirements is not necessarily inappropriate. However, the Commission does not take this approach, except with respect to the debt in the limited fashion just described. Carried to its logical conclusion, each security and its income requirements would be applied to the estimated income to determine the total securities which would be issued. This method would suggest the use of various rates of interest and percentage dividend requirements. These would become equivalent to rates of capitalizing the several segments of income. The specific rates of capitalization or discount which should be applied on an overall basis and to the several segments of income may not yield substantially different results from a single rate to find an overall valuation, but the Commission has not demonstrated this.

The quantity of debt and other prior securities allowable in the capital structure is believed to be dependent on income and asset coverage. An examination of feasibility standards will be made in Chapters IV and V, and an examination of the tax effects under the segmented earnings method will be made in Chapter V. Most of the remainder of the present chapter will be devoted to an analysis of the Commission's overall rates of capitalization and discount.

The rates of capitalization used.- In its pre-1942 cases on which advisory reports were rendered, the S.E.C.'s rates of capitalization varied between 8.7 per cent and 12 per cent of the before-tax income. Since the rates tended to center on 10 per cent, which was

selected in a number of cases, and variations were only 13 per cent below and 20 per cent above 10 per cent, one could judge that a rate of about 10 per cent was considered by the S.E.C. to be about normal for industrials. Deviations above 10 per cent were higher than those below; however, this is inherently likely to be the case with 0 per cent as the lower limit. The tendency for the rates to cluster around 10 per cent is hardly consistent with the Commission's emphasis on stability of earnings as a criterion.

In the case of La France Industries, a rate of 9 per cent was used for the Canadian subsidiary (49, p. 12). The American units of the same company had their earnings capitalized at 10 per cent. The Canadian subsidiary had sustained no losses during the six-year earnings period while the American units had suffered substantial losses in some years. Such a difference in stability of earnings would seem to justify a greater difference in rate of capitalizing these earnings.

In the reorganization of the Minnesota and Ontario Paper Company, several distinct types of activities were carried out by separate divisions (50, pp. 7-9). The earnings from the sale of newsprint and of wallboard were highly unstable, while those from the operation of a toll bridge and the production of electric power were highly stable. The same rate, 10 per cent, was applied to all divisions. Since the latter two divisions were comparatively small, a vastly different rate than 10 per cent would have made little difference in the overall valuation. Yet in other cases where varying rates were used for different divisions, the spread between these rates are quite small. The spread between the different companies in entirely different industries was quite small, not more than 27 per cent of the highest rate (12 per cent)

used for those companies of an industrial nature whose rate of capitalization was clearly stated (59, p. 10) (60, p. 19). The Commission has not stated a standard for the establishment of specific rates of capitalization related to certain degrees of risk and uncertainty, even though it consistently states that the degree of risk determines the rates.

It would be difficult to know if an average rate of capitalization of about 10 per cent of the before-tax earnings was appropriate for industrial corporations coming out of reorganization at that time. The Commission's rates were much lower than those set by Dewing, who was stated as the authority on rates of capitalization (11, pp. 335-336). Speaking of a 10 per cent rate or a multiplier of 10 times "normal earnings," Dewing states "this is the highest value that can possibly be assigned to an industrial business" (11, p. 335). It should be noted that Dewing was speaking of after-tax rates, which at that time would have meant a before-tax basis of around 16 per cent. The fact that the liberal rates selected by the Commission were so much below Dewing's minimum rate might be accounted for by the upward earnings trends of industrial companies of normally high quality. But, it is also possible that Dewing's rates were too high or that other considerations were involved.

Dewing's suggested rates at the time varied from 10 per cent for long established industrial corporations with minimum risk to 25 per cent for small businesses of special character (11, pp. 335-336). By their nature, most of the industrial companies on which advisory reports were rendered prior to 1942 would fall into Dewing's intermediate classes (between 20 and 35 per cent before taxes). By these standards,

the rates allowed by the Commission were far too liberal, if the Commission intended the rates to reflect the actual and comparative risks into the future, as it properly should.

In later cases, the Commission sharply increased the recommended rates of capitalization. In the Indiana Limestone Corporation case, the Commission applied a rate of 15 per cent to the net income before taxes (4:18;192). This would have been a rate of 9.3 per cent after taxes. In the case of Keeshin Freight Lines, Incorporated, the Commission used a capitalization rate of 15 per cent after taxes, considering the "conservative nature of the estimated earnings but at the same time weighing the risks inherent in this highly competitive industry . . ." (4:29;738). In the case of Muntz TV, Inc., the Commission capitalized the after-tax income at 12 per cent (4:36;323). In the case of the Green River Steel Corporation (73, p. 15), and the Northeastern Steel Corporation (74, p. 19), a rate of 12-1/2 per cent was applied to the after-tax income.

The rates shown above would fall into Dewing's second category (12-1/2 per cent) for old well established businesses "requiring considerable managerial care" (40, p. 390).

While the lowest rates of capitalization found in the securities markets vary considerably over short periods of several years, price-earnings ratios below 8 times (12-1/2 per cent) are presently rare on well seasoned common stock. It appears that Dewing has not kept pace with the trend in thought regarding growth in stock values. By 1953, Dewing had revised his classifications by adding two higher categories (40, p. 391). The sixth category, industrials which involve little capital and are highly competitive and dependent on

unusual skill of management, would be capitalized at 50 per cent of net earnings or approximately 100 per cent of before-tax earnings, in some cases. The seventh category, personal service businesses, would be capitalized at twice these amounts. In the opinion of the writer, these rates are far too high and would cast doubt on the validity of the other five classifications.

Rates of discount.- In the selection of rates of discount to apply to future cash income of firms with limited economic life, the early cases present little evidence that the Commission's philosophy as to the appropriate level was substantially different from the rate of capitalization used for firms with perpetual life. Possible exceptions were those cases which involved depleting natural resources. In these cases the Commission utilized the standards established by trade associations and government agencies, but made large adjustments for the "risk" factor. In the Penn Timber Company case, expert testimony was accepted to the effect that "two factors must be considered in determining the particular rate of discount - namely, an allowance for interest and an allowance for general risks of timber losses and unforeseen business adversities" (4:7;172). It was testified that the Forest Service used 4 per cent for pure interest, and the Commission accepted this, but added 6 per cent for risk, for a total discount rate of 10 per cent.

In early years, the rates of discount were within the range of 8 per cent to 12 per cent, or about the same as that for the rate of capitalization. In later years, rates of discount with a few exceptions remained at these levels while rates of capitalization advanced. This may be explained in part by the underlying quality of the companies

concerned. However, it should be kept in mind that the rate of discount and the rate of capitalization are not directly comparable, since the former is applied to earnings before depreciation, and for a fewer number of years. With the same rate, the larger earnings before depreciation produce a larger annual value which includes a return of capital. The Commission did not always make the distinction clear in selecting its rate of discount. In the Philadelphia and Reading Coal and Iron Company case, it was said that "in the light of the uncertainties of the Debtor's prospects, particularly with respect to the duration and effect of the war, rates of return or discount comparable to those that might be applied to investment situations would here be inappropriate and in our opinion a rate of 15% to 20% would be required to reflect the speculative character of the Debtor's prospects" (62, p. 38). Not only was a high rate of discount applied, but the net cash proceeds were calculated for only five years. The remaining value at the end of five years was calculated on a liquidating basis at about 35 per cent of the total valuation. The Commission reduced the liquidating value by $1,750,000 or 20 per cent of the amount found by the court appointed examiner (62, pp. 38-39). These assets, for the most part reflecting current assets, were discounted at an 8 per cent rate.

In the early Atlas Pipeline reorganization, a 12 per cent rate of discount was applied to net cash proceeds before depreciation (51, p. 24). Operating life was estimated at five years and the expected cash proceeds from current assets were discounted at 6 per cent. Similar findings were made in other natural resources cases. At least two important points concerning the Commission's application of methods are brought out by these cases. First, the Commission tends to apply

seemingly high rates of discount to net cash proceeds which are expected to accrue within very short periods. Second, the Commission applies a substantially different standard for different kinds of assets. Cash and other current assets are discounted at relatively low rates, but from 50 to 100 per cent above the approximate market rate of interest. Rates of discount varied as much as 250 per cent for the different types of assets. Since approximately 4 per cent of the rate was pure interest, the actual risk variation was 550 per cent. The higher rates producing such variations are hardly justifiable in view of the short recovery periods assumed.

Since the industry sources, regulatory commissions, and other governmental agencies are likely to provide reasonably accurate estimates of reserves and sales, rates of discount including the return of capital have the effect of producing conservative valuations of natural resources companies. This is reflected by the Commission's statement in the case of the Parker Petroleum Company (4:39;548). The S.E.C. applied a rate of discount of 10 per cent to the estimated income after taxes and administrative costs. It also applied a 10 per cent rate to the present value of the income tax loss carry-over. The Commission rejected the 6-1/2 per cent market discount rate offered by the independent expert employed by the Trustee, stating that it was possibly an appropriate rate for the secured debt of a successful company, but "not acceptable as a discount rate for the determination of going concern value of the Debtor" (4:39;563). Two-thirds of the net cash was estimated to be recovered in six years, although a 20-year life was assumed.

Capitalization of higher earnings.- One additional class of cases is considered, namely, where the future earnings to be capitalized

are assumed to be higher than past levels. It appears that the Commission erred in its approach to this problem, however, each of the cases analyzed involved offers to merge by exchange of stock. In such cases, a liberal valuation would provide greater participation by the senior and, possibly, the junior security holders. The finding of a higher valuation than indicated by the facts is presented in the Northeastern Steel case (4:38;41). Net sales had been $12,700,000 in 1955, and $15,700,000 in 1956. The estimate of future earnings and valuation made by Arthur D. Little, Inc. was questionable. The Commission, however, used the Little report's estimated sales after four years, with the reservation that "average net sales volume on a long-term basis, well in excess of the $23,542,000 estimated by Little can reasonably be expected" (4:38;55). The Commission said that it assumed a future profit rate of between 6-1/2 per cent and 7 per cent, which was a compromise between the Little report's recommendation and the rate realized by seven selected similar steel companies. The Commission also gave attention to these companies' weighted average price-earnings ratios in selecting a 12-1/2 per cent rate of capitalization after Federal income taxes. The market rates of capitalizing comparable companies were based on net operating profit for the <u>previous</u> year, but the market value of capitalization, with debt and preferred stock taken at principal or par value, was as of the <u>close</u> of that year (74, p. 13). Common stock, however, was taken at the low, high, and bid for the first five months in the <u>current</u> year. The rate of capitalization selected, while varying slightly from the mean of the similar companies' rates, was applied to <u>future</u> earnings which were expected to be achieved after four years. While requiring additional investment to reach the

projected level, the investment necessary to reach that level was deducted from the "gross capitalized value" (74, p. 19). A quite similar procedure was used throughout for Green River Steel Corporation (73, pp. 9-16).

While the procedure and its results may be considered quite liberal, it is apparently defective. Present market rates of capitalizing present income theoretically anticipate future income. It is suggested that, in cases in which the earnings are selected somewhat subjectively, the rate of capitalization should be selected in the same manner. It is further suggested that, if the Commission uses the adjusted recent level of earnings as the basis for its earnings estimate, it should use an adjusted recent market rate of capitalizing the earnings of comparable companies. If the S.E.C. bases its earnings estimates on a number of past years, it should use the long-term rates at which the industry has been capitalized. This would provide a choice of methods in each case considered. The Commission, also, should have an opportunity to depart from this standard, with an explanation that it is doing so and the reasons for the departure.

Rates of capitalization, again with some exceptions, may be considered liberal by the early standards used, but not by comparison with present day standards. Rates of discount may be conservative considering the relatively short nearby recovery period of the earnings. Except with respect to different risk classes related to specific industries, in capitalizing earnings of companies being reorganized, it should not be concluded that higher rates should be used because of the recent unfavorable history of the debtor corporations. Rates close to the industry average may be justified since reorganization presumes to

eliminate the specific cases of failure.

Probably the greatest defect in the Commission's method is its failure to explain the rationale for the specific rates of capitalization selected. The Commission goes to great lengths to explain its analysis of sales, costs, and profitability and all factors bearing on them, but usually in one short phrase selects a rate of capitalization or discount without explanation, which has the capability of producing highly varied total valuation. For example, the difference between a 10 per cent rate and a 12 per cent rate is a difference of 20 per cent in valuation.

The overall valuation.- The capitalization of earnings is usually the main element of valuation, therefore, the accuracy of the estimates of its two components is of greatest importance to the overall valuation. Since the earnings estimates of the S.E.C. must be conservative, the indicated outcome is conservative valuations. However, a conservative (low) earnings estimate may be totally offset by a liberal (low) capitalization rate. The Commission may be on safer ground in producing a conservative valuation through the rate of capitalization selected than through the earnings estimate. The former is the more subjective and has few standards for direct comparison, while the latter may be challenged by comparison with the company's operating data. Even so, the earnings are usually trimmed down as the rates of capitalization are increased. In the process, the Commission may seem to be liberal in the rate of capitalization selected by comparison with the standards it presumably uses.

It should be noted that a conservative earnings estimate cannot be offset with a proportionately liberal rate of discount for a firm

with very limited future life. The present value of an income of $500,000 per annum discounted for 5 years at an 8 per cent rate of discount is $1,996,805, whereas that of an income of $1,000,000 per annum discounted for 5 years at 16 per cent is $3,274,290, or 64 per cent more. It is difficult to determine whether rates of discount and capitalization are held within narrower ranges than earnings estimates by the Commission, but it appears that they are not. The very existence of the operating data would suggest that earnings estimates vary the least from the middle of their possible range.

Means other than the capitalization of earnings are available to raise or lower the total valuations. The major classes of property affected are liquidating properties and properties valued on a liquidating basis when liquidation is not necessarily planned. Although the latter cases presume to find higher values than the going concern values for the same properties, the liquidation value may itself be conservative. The Commission seems to have been particularly anxious to liquidate properties whose future earning power is questionable (51, pp. 22-24), and for which there is a specific cash offer which does not deny full compensation to creditors (90, pp. 12-15). The effect of such liquidations may be to benefit senior security holders at the expense of junior security holders, depending on the amounts received, the total valuation, and the amounts of the various claims. If only part of the property is disposed of, more cash is realized immediately and the rate of return on the remaining assets is probably higher, but the total valuation may be lower.

While some properties are clearly not essential to the main business or not as valuable in a going concern as if liquidated, other

property values have a direct bearing on the going concern valuation. Excess working capital is added to the capitalization of earnings value. Deficient working capital is a direct deduction from the capitalization of earnings value. Therefore, the accuracy with which the Commission estimates the working capital needs is highly critical to the overall valuation. Excess working capital, particularly cash, usually leads directly to a partial cash distribution to the senior security holders. In almost every case, except those requiring additional capital expenditures, the Commission reduced the estimate of working capital required below that recommended by the trustees or the various expert witnesses. This would have the effect of increasing the overall valuation. However, in most cases, the Commission reduced the earning power valuation found by the trustee and others by at least the amount of the excess working capital established. Upward and downward adjustments of the earning power basis may be numerous and large in amounts, and may be made subjectively, in part. In the Green River Steel case, the capitalized value was subject to an upward adjustment for a tax saving of $2,118,000 on the one hand and a downward adjustment of $6,415,000 on the other for additional plant expenditures needed to produce the postulated income (73, p. 16). This would then be adjusted upward by $600,000 additional income generated during the period of reorganization. Therefore, $3,700,000 would be deducted from the capitalized value of $16,800,000 to produce a valuation of $13,100,000.

The Commission's reduced valuations turned out to be lower in almost every case than those recommended by the trustees and those established by the market values of securities outstanding in later years. At least two cases, the Deep Rock Oil (48), and the Flour Mills

of America (60), were very unusual in that both the trustee and the courts found values far in excess of the Commission's findings and the former proved to be correct by the market value of securities outstanding test. In the Deep Rock Oil Corporation reorganization, the S.E.C. found a valuation for the producing and non-producing properties of $7,150,000, which was considerably less than the valuation of $16,800,000 made by the trustee in September, 1936 (48, pp. 16-18). In the earlier action, the District Court had found the properties "were of a value not in excess of $17,000,000" and this was accepted by the Supreme Court (48, p. 17). The Commission expressed the belief that "neither the District Court nor the Supreme Court did more than fix a maximum value which could be attributed to the property of the Debtor" (48, pp. 17-18). The S.E.C. believed that the earlier appraisal, which was based on reproduction costs, was erroneous and that the properties should be appraised on their lower going concern value. Within five years, the market value of securities outstanding was over $20,000,000, or 261 per cent of the S.E.C.'s valuation (24, p. 23).

In the case of Flour Mills of America, Incorporated, the trustee had estimated earnings at $250,000, after depreciation (4:7;17). These were capitalized at an 8 per cent rate by the trustee. The Commission believed the earnings forecast was unduly optimistic, but was willing to accept it, if a rate of capitalization no lower than 12 per cent were used (4,7;18). This would produce a value of $2,160,000, which, when compared with liabilities of $2,900,000, would render the company insolvent. The senior security holders were willing to accept a lower rate of capitalization, rather than forced liquidation. Under the plan, the preferred stock would have participated. The court

subsequently approved a plan finding the corporation solvent. It stated the valuation to be "reasonably in the amount asserted by the trustee" (4:7;30). Within six years, the market value of securities outstanding totalled over $4,000,000 and the following year over $6,000,000 or 188 per cent of the S.E.C.'s valuation (24, p. 23).

Conclusions.- In general, the techniques of valuation, especially those applying to estimates of earnings, are highly refined, but the large number of factors to be considered present possibilities of error here, as well. To the procedures, the S.E.C. lends an air of authority as to the wisdom of its choices. Such choices are in the hands of a relatively small number of presumed experts, who may be influenced by a preknowledge of a desirable outcome. At least when quantitative data fail to produce the desired valuation, intuitive knowledge of the probable economic value may come into play. In such cases, failure to predict a long-term trend in the economy may play havoc with the assumed long-term values. Probably, the Commission should not be held responsible for this. Reference is again made to the Consolidated Rock Products case in which it was said that a determination of earning power requires a prediction as to what will occur in the future, an estimate, as distinguished from mathematical certitude (3, p. 685). The writer believes that the statement was meant to infer that a well reasoned estimate is the best that may be expected. Since the law requires that an earning power valuation be made, the courts, with the assistance of the S.E.C. in Chapter X cases, attempt to do so. If the S.E.C. fails to estimate value correctly, then it must be due to some reason other than the fact that history proves it wrong. Economic conditions change, affecting costs and revenues either favorably or

adversely.

The possibility exists that the Commission may be deliberately conservative in order to protect itself from criticism in case of later financial difficulties in corporations whose reorganizations they approve (79, p. 27). However, the Commission seems to be governed more by the requirement to protect the interests of public investors, particularly senior creditors, under the absolute priority rule. The Commission's findings seem to be designed more for that purpose than to find a "true" valuation. However, this cannot be proven. It appears that the S.E.C. can produce a wide range of possible values in any one case, through the use of accepted techniques. The valuations chosen in most cases appear to be conservative, except where a liberal valuation would benefit the security holders of the debtor corporations.

The rate of capitalization is a very effective instrument in the hands of the S.E.C. Its percentage amount has little basis in the literature. At first, the rates were supposedly based on the standards established by early authorities, although the relationship between the two has not been established by the S.E.C. Later rates have no stated standard except relative risk of achievement. It is questioned whether the rates selected offset conservative earnings estimates. This writer has suggested the use of market rates of comparable companies as a practical approach to this problem.

Corporations have almost always gone up in value, and, apparently seldom, if ever, fail after approval of the plan of reorganization by the S.E.C. It is entirely possible that the improved values found in corporations after Chapter X reorganizations may be due in large measure to the recommendations of the S.E.C. to reconstruct

proposed plans of reorganization into good overall plans. Conservative valuations may very well provide the foundations for plans which will be feasible and demonstrate improved results, and still be fair and equitable to those who participate. Liberal valuations may very well provide more equitable treatment to all classes of former security holders. It is posited, however, that for plans of reorganizations to be equitable, valuations should be neither excessive nor deficient. The specific requirements of fairness and equity and feasibility will be examined in Chapter IV.

CHAPTER IV

PLANS OF REORGANIZATION

The purpose of this chapter is to determine the legal requirements of fairness and equity and of feasibility, and the specific order of priority under the absolute priority doctrine, and to determine how the S.E.C. has utilized the doctrine to disapprove specific plans of reorganization. Approved plans of reorganization will be examined to determine what types of plans are approved, and whether they are fair and equitable between classes of security holders, and to establish what types of plans result in the most equitable treatment of each class of security holder.

Requirements of a Fair and Equitable Plan

General requirements

For the general requirements of fairness and equity, reference is made to several sections of Chapter X of the National Bankruptcy Act which require that a plan of reorganization thereunder be fair and equitable (1:52;891) (1:52;897). This Act was discussed in Chapter II. Reference is made also to the precedent legal cases which established the absolute priority rule for Chapter X reorganizations. The absolute priority rule was reaffirmed in the Los Angeles Lumber Products Company case (2, p. 106). It was established that the underlying doctrine of fairness and equity as applied in corporate reorganizations is that

participation would be according to legal contractual priority claims, and that no participation should be permitted when no equity in the corporation exists, without additional contribution in money or money's worth to establish that equity.

Under Chapter X, as administered by the courts and the S.E.C., the application of the absolute priority rule requires a determination of the claims which are to be recognized and the amounts of these and the qualitative and quantitative manner in which each of these claims is to be compensated. The valuation found determines the total value to be distributed.

Claims to be recognized

Enforcement of contracts.- Securities contracts are to be strictly enforced under the absolute priority rule. The legal precedent for the priority of each type of security will be presented as each type of security is discussed. The S.E.C. cited the legal precedents for priority in many early cases, e.g., Flour Mills of America, Inc. (60, pp. 22-25).

The general order of priority.- The general order of priority of creditors and stockholders is approximately as follows:

1. Mortgage bondholders and holders of collateral trust bonds having liens on specific assets.
2. General creditors and debenture holders.
3. Preferred stockholders.
4. Common stockholders.

Although there may be many more classes than this, it is usually clear which security might have a priority over another. However, there are frequently instances of disputes due to discrepancies between the

contracts governing two classes. Intricate balancing of claims is necessary when mortgages cover various properties, when second and third liens exist on various properties, and when the assets are insufficient to compensate all mortgage holders and free assets also exist as to the unsecured creditors. This may necessitate separate valuations of separate properties.

Senior creditors' liens.- Senior creditors are to be recognized as to their full liquidation rights in reorganization. In the Consolidated Rock Products case, it was held that all claims mature in reorganization, therefore, the absolute priority rule is applied to solvent, as well as insolvent situations (3, p. 685). In both situations this will mean the full face amount of principal and accrued interest.

In the Deep Rock case, the Commission said that interest should accrue to the date of payment (48, p. 19, n. 75). It also stated that "the authorities clearly support the proposition that, at least as between the creditors and stockholders, the interest on the notes must be considered on a parity with principal" (48, p. 20, n. 79). In the Childs Company reorganization, the Commission was successful in its contention that partial payments should be first applied to accrued interest and then to principal (91, p. 144).

Junior creditors.- Junior creditors are not to receive participation without additional contribution when no equity exists for them (92). Priority between secured and unsecured or second lien creditors is as to the mortgaged assets. Debenture bondholders are ordinarily classed co-equally with general creditors.

General and unsecured creditors hold a priority position junior

to mortgage holders and senior to stockholders. Their position in reorganization is a general lien on assets, irrespective of their prior positions with respect to earnings. General and unsecured creditors have a pro rata claim on unmortgaged assets. However, in preparing reorganization security contracts, previously weak claims are likely to be continued as weak securities compared with stronger claims of the general same class. The Commission expressed this idea when it said that the absolute priority rule requires that "the apportionment of the new securities be appraised not only on the basis of the values of the claims being surrendered but also on the basis of a comparison between the terms and priorities of the new securities and of the old" (50, p. 75).

Senior equity interests.- In cases in which the corporation is insolvent in that the valuation is insufficient to equal the creditor's claims, the stockholders are not entitled to participate, as a right (2). The same standards apply under the absolute priority rule, whether the corporation is insolvent in the bankruptcy sense or not. Fairness and equity between creditors and stockholders of a solvent corporation is dependent on allocation of participation to stockholders only to the extent of their equity, except on the basis of contributions to the corporation (93).

The senior equity security normally will be preferred stock. The courts and the S.E.C. in Chapter X cases treat preferred stock claims as matured and entitled to their liquidation rights (94). This will mean holders of preferred stock should receive participation at least equal to stated liquidation value and accumulated dividends. The preferred's liquidation value may be par value or more in case of

involuntary liquidation, and is usually higher, say, the call price, if the liquidation is voluntary (58, p. 24, n. 34). This will mean relatively favorable treatment for preferred stock claims to the extent an equity remains.

Junior equity interests.- Participation by Class A stock "must not be at the expense of the bondholders' right to receive fully compensatory treatment" (90, p. 15). Class A stock is entitled to its legal liquidation preferences, including any accumulated dividends, to the extent an equity remains for it. Liquidation preference would normally be the par value of the stock. Fairness and equity between different classes of stockholders requires full compensation to the senior class of stockholder before a junior class may share (95). Common stock, as the residual claim, is entitled to participate to the extent of the residual value only.

Qualitative and Quantitative compensation

The precedent cases include numerous passages which demonstrated that holders of old securities could receive new securities unlike those they previously held and like those received by classes having less priority. Such changes involve qualitative and quantitative measurements of both the old and the new securities contracts. Herein, only very general rules of compensation will be presented. The entire area is extremely complex and is often unsettled. See Blum and others for detailed analysis of the difficult questions of the law and its application (96, pp. 85-113) (97, pp. 900-921) (45, pp. 565-603) (98, pp. 417-444).

Full compensation.- Full compensation is required for the

surrendered rights of holders of senior creditors' liens. In the Consolidated Rock Products case, it was provided that "full compensatory provision must be made for the entire bundle of rights which the creditors surrender" (3, p. 686). The Los Angeles Lumber Products case provided that creditors should be accorded their full rights of "priority against the corporate assets" (2, p. 122). Operating on this general principle of the absolute priority rule, the major problem of the courts and the S.E.C. has been to determine what constitutes full compensation.

The precedent cases contemplate full compensation according to full liquidation rights, but based on going concern value rather than liquidating value. A determination of the adequacy of the compensation is to be in the discretion of the courts. In the Consolidated Rock Products case, it was said that "creditors are entitled to have the full value of the property, whether 'present or prospective', first appropriated to payment of their claims" (3, p. 686). Under Chapter X, the S.E.C. seems to interpret this to mean a requirement to measure and compensate on the basis of nominal or face values rather than immediate or even ultimate market value. In order to compensate senior claims for qualitative loss, the S.E.C. will normally see that the holders enjoy a quantitative gain in the award of junior securities. Preservation of priority means not just preservation of position, but preservation of rights, as well.

Extensions of maturity.- Extensions of maturity require additional compensation to constitute full compensation (52, p. 9). While this is only one of many ways that sacrifices may be imposed on old security holders, it is somewhat more intangible than a reduction in principal or in interest. Reorganization first accelerates and matures

old claims and then extends them for an additional period, except for that portion of the claim which is paid in cash. The new period may be longer or shorter than the old period. If the maturity is extended, the absolute priority rule requires that the extension be fully compensated. No evidence was found of reductions due to acceleration, as such. As a matter of fact, payment in cash or very short-term instruments is usually looked on as favorable to creditors. Under the feasibility criteria, continuation of a burdensome requirement to the corporation is to be avoided in reorganization, although one might argue that a favorable contract, to be fair to creditors, should be continued. These considerations are the most difficult to be found in reorganization.

Sacrifices not subject to measurement.- It appears that the Commission usually weighs in the balance significant sacrifices not subject to precise monetary measurement. Payment in cash to security holders in the face amounts of principal and accrued interest of accelerated claims may be a desired objective in reorganization, but it is certainly not a requirement. When reorganization rather than liquidation is indicated by the valuation process, the new plan is conceived so that security holders may realize the full going concern value "in the form of future principal, interest, and dividend payments (50, p. 75). This permits claims to be evaluated as to the quality of the claimants' contracts in deciding on the appropriate award of new securities. The procedure contemplates their replacement with a new bundle of rights approximately equivalent to the old bundle. Creditors are entitled to payment of no less nor more than this bundle. This requires considerable subjective analysis.

Control of the corporation as compensation.- Other sacrifices demanded by standards of feasibility require a step-up in compensation. This may take the form of control of the corporation or some other *quid pro quo*. Innumerable cases exist in which the former creditors emerged with all or part of the common stock (69, p. 9). Control, itself, is considered to be of value for purposes of compensation. However, feasibility determinations often result in a largely common stock capitalization. When creditors are forced to take common stock for all or a portion of their claims, the common stock is normally awarded in much larger nominal amounts than the surrendered securities. The limitation of the voting right of a new security proposed for junior interests cannot be treated as a concession to senior interests (99, p. 15). Furthermore, the issuance of new non-voting stock is prohibited under Chapter X. (Sec. 216(12). In the case where a majority of the value of the reorganized company will be in the hands of holders of preferred stock, they may receive rights to vote at stockholders' meetings, although not necessarily control. Old preferences as to voting in case of default may be continued, or new rights may be added in order to provide a right which is normal for the type of security. This often means the right to elect a majority of the board of directors in case eight quarterly dividends are passed. Such protective provisions, while not necessarily a part of a plan of reorganization, are usually recommended by the S.E.C. to be included in the certificate of incorporation.

General fairness.- General fairness is always a requirement over and above strictly mathematical distribution of values. However, under Chapter X the courts are not required to find the fairest conceivable plan (100, p. 618). Yet, the S.E.C. has commented in many

cases on the degree of unfairness which would result from a given plan. It may be assumed that if the plan were approved, in toto, it is generally fair. Some unfairness is always present, but in a legal sense, this is permissible if every attempt was made to avoid it. The Commission attempts to accomplish improvements by suggesting amendments, even in plans which it finds to be fair and equitable and feasible.

Legal exceptions to absolute priority

There are three important legal and judicial exceptions to the absolute order of priority. The exceptions are important in that they may be immediately beneficial to public creditors and to public equity interests.

Legal compromise of claims.- Settlement of conflicting claims is a part of the process of reorganization (2, p. 130). In the Hudson & Manhattan case, the Commission stated that under "appropriate circumstances, economical administration of the proceeding might point to the compromise of conflicting claims as to priority or as to specific assets. Fairness does not preclude settlement of such contentions" (4: 38;711). In the Keeshin Freight Lines case, the Commission said that since the eleven major business corporations, which held the notes of the parent company, were not members of the investing public, it saw no reason why they could not accept parity among themselves (85, p. 21). Certain other creditors had agreed to subordinate their claims to the claims of the other general creditors. The Commission found this satisfactory, also, since it did not adversely effect public creditors or stockholders.

In the Green River Steel case, the S.E.C. stated that the plan was fair to the Government (R.F.C.) since "as the single creditor of

its class, it is receiving a participation equal to that which it has indicated it is willing to accept" (73, p. 21). This amounted to a reduction of several million dollars in principal, a reduction of the interest rate, and an extension of maturity. Such voluntary compromises and subordinations of claims may go far toward making more value available to public investors.

Judicial subordination of claims.- Under the Deep Rock Doctrine, it is possible to subordinate claims judicially in cases of acts of mismanagement (101). This doctrine makes additional value available to all creditors and equity interests with new priority above the subordinated claims. The abuses or acts of mismanagement by Standard Gas and Electric Company included insufficient provision for capitalization of the subsidiary, payment of dividends to the parent when Deep Rock was financially unable to do so, and other detrimental actions (48, pp. 2-5). Claims have been subordinated or eliminated in a number of Chapter X cases, e.g., Texas Portland Cement Company (4:40;1080).

The "six months claims".- The "six months claims" class of interest is another judicially justified exception to the strict application of the absolute priority rule. In a very early railroad reorganization, it was decided that certain classes of unsecured creditors would have to be paid in order to keep the railroads operating during the reorganizations demanded by public policy considerations (102). The "rule in Fosdick v. Schall" allowed the receiver, and later the trustee to meet all current expenses before any current income could be used to meet the bond interest, leases, and capital charges. Any income which had been "deflected" prior to the courts' taking over the assets would, also, be denied to mortgage holders, if needed to meet

current expenses. The "rule" has been expanded to include a large number of specific items, now generally known as "six months claims." Such claims are seldom mentioned specifically with regard to priority in the Advisory Reports. However, they have the effect of elevating certain classes of governmental and private claims above those of mortgage holders. This is not necessarily unfair, since receivers' and trustees' expenses are necessary to conserve the property for the interest of the creditors.

Procedural aspects of fairness and equity

Treatment of eliminated classes.- The procedural aspects of voting on plans of reorganization were outlined in Chapter II. Valuation of assets and evaluation of claims determine which classes may participate in proposing plans and in voting on them. However, eliminated classes are permitted to participate in hearings to establish the valuation and have "the right of appeal to correct irregularities or errors in the valuation process" (45, p. 589).

The cram-down authority.- Plans of reorganization may be offered by both senior and junior interests. Majority bondholders are in a position to veto plans which the courts might approve, but which are not sponsored by the majority. However, "the 'cram-down' provision of Section 216(7) of Chapter X permits confirmation of a plan which has not been accepted by the requisite majority of creditors" (103, p. 11). According to the Commission, the extent to which this section may or should be invoked is a matter of question. It appears that its use is avoided whenever possible, especially against senior interests (45, p. 590).

A plan of reorganization offered by the trustee may provide that any or all of the property may be offered for sale "at not less than a fair upset price" (1:52;896). When approximately equal offers are found to be fair and equitable, the court may resort to the public auction, but the terms of that auction may be prescribed and liberalized in order to encourage competitive bidding. The use of an "upset price" in Chapter X is not resorted to very often. It is most likely to occur when there is a dispute between senior and junior interests as to whether to sell or to reorganize (45, pp. 590-591). While both classes are to be included in the plan, immediate liquidation may be favorable to senior interests at present market prices, while continued operation with possible increase in residual values is favorable to junior interests. The "upset price" must be fair, but not necessarily the reorganization value on which the plans were predicated. According to Blum, "more than one court has remarked that under it juniors are as well treated as they could expect to be under a fair reorganization plan" (45, p. 593).

Voting trusts.- The Commission does not seem to favor voting trusts, even though Section 216(11) of Chapter X provides for their selection (1:52;897). The Commission is concerned that the device tends to permit continuation in power of those who were responsible for the original failure (104, p. 136). However, the courts have approved voting trusts, which can be a protection to security holders if properly governed.

Requirements of a Feasible Plan

Under Chapter X, a plan of reorganization must be feasible as

well as fair and equitable (1:52;891,897). The S.E.C. has said that the purpose of reorganization is to permit the corporation "to readjust its affairs in order to continue as a sound going concern" (50, p. 75). It is mainly because of this readjustment that the feasibility requirement is so important to the question of fairness and equity. Steps taken in the name of feasibility may so change the form and amounts of the new capital structure that it is difficult to maintain fairness and equity to each class of security holder.

It has been said that the "meaning of feasibility is not so clear nor so well established," as the meaning of fairness and equity (104, p. 125). With so little legal background for feasibility standards, the Commission has advised on the matter almost entirely without reference to precedent cases.

The general requirements

The Commission's general requirements on feasibility have been stated as follows:

> Among other things, feasibility requires a sound capital structure, an assurance of adequate working capital, and that the securities issued not be deceptive. The company must have sufficient cash, working assets, and earning power so that it will be assured of covering by an ample margin all of its financial obligations, including the making of capital expenditures when required and the payment of interest and principal on its debt obligations when due (74, pp. 21-22).

Prevention of future insolvency.- Prevention of future insolvency is one of the objectives of a sound plan of reorganization. This requires that the corporation not "emerge from the reorganization in an insolvent condition" (61, p. 4). The corporation must be able to honor its obligations as they mature. This will require that even liquidating corporations have sound financial plans (71, pp. 18-19). The principle

extends further than just the immediate future. In the Milwaukee case, it was said that the company should have sufficient quantities of cash, working capital and earnings to be assured of meeting all its financial obligations by an ample margin, including the required capital expenditures and payments of interest and principal when due (39, p. 727).

Prevention of future economic failure.- Prevention of future economic failure underlies many S.E.C. determinations on feasibility in Chapter X cases. It has been said that courts do not give "much attention" to the problem of future economic failure (104, p. 126). Steps to prevent future economic failure involve mainly the types and quantities of securities to be issued and the quality of the new management. A safe way to avoid failure in the short-run and postpone failure over a longer period is to adopt a financial plan with no debt or other fixed obligation securities. In the Porto Rican Tobacco case, the S.E.C. said that since the capital structure of the liquidating corporation would be entirely common stock, no problem of feasibility would exist (90, p. 14). Such a stringent requirement may avoid technical failure for a time, but is not appropriate for most going concerns, and for many companies being reorganized. The Commission has recognized the need for some prior securities in most cases, therefore, many feasibility determinations concern their provisions and quantities. On occasion the Commission has made suggestions regarding the new management. In the case of National Radiator, the Commission said, "a vital element in the feasibility of any plan is the quality of the management" (105, p. 7). Half of the new Board of Directors had long been identified with the company, but half were new.

Protection of public investors.- Protection of public investors

is also a feasibility requirement. The legal basis for this requirement goes back to Section 77B. In the American Department Stores case, the court said:

> It is the duty of the court to pass upon the feasibility of the plan of reorganization. Although the plan were unopposed, the court should not approve any feature fundamentally unsound . . . . Congress in subdivision (h) of Section 77B . . . provided that: "All securities issued pursuant to any plan of reorganization confirmed by the court in accordance with the provisions of this section, . . . shall be exempt from all the provisions of the Securities Act." This imposes upon the courts the task of scrutinizing with care securities to be issued under a plan of reorganization (106, pp. 979-980).

The requirement applies to future purchasers as well as present security holders. It has been said that securities to be issued under a plan of reorganization shall not be misleading by their terms, or otherwise, to subsequent purchasers (107, p. 247).

Securities issued in Chapter X reorganizations are exempt from the Securities Act of 1933 (51, pp. 27-28). The additional responsibility imposed on the courts by this exemption was recognized in the case of Barlum Realty Company (108). It appears that this express exemption was based on the belief that approval of plans of reorganization by the courts would provide sufficient protection to public investors. The S.E.C. sees this as an additional responsibility, and has advised against specific securities on the grounds that the public interest was at stake in a number of cases, e.g., the Griess-Pfleger Tanning Company (52, pp. 11-13). The S.E.C. has interpreted the requirement very broadly to include securities for which it believes earnings may not be available in sufficient quantity.

Adequacy of working capital.- Adequate working capital is an obvious requirement of all plans of reorganization. Payments to

creditors should "leave the debtor with sufficient working capital to finance its requirements with normal banking accommodation" (58, p. 27). The Commission seems to have no specific standard for the sufficiency of working capital. However, it has made estimates based on sales volume in some cases. In The Higbee Company case, it was stated that "the debtor requires approximately 22.5 cents of working capital for each dollar of sales" (69, p. 20). In the Green River Steel case, a working capital ratio of 15 per cent of sales was said to be low in relation to needs and as compared with other electric furnace steel companies (73, p. 17).

Other requirements.- Other requirements of feasibility are related to the simplification of capital structure, the flows of present and future earnings, and proposed present and future financing. These problems are interrelated and very important to the major thesis. Consequently, they will be analyzed in detail in Chapter V.

Disapproved Plans

In its advisory capacity, the S.E.C. has shaped the courts' attitude on such matters as allowable expenses of reorganization, the proper statute for relief, and other matters which are outside the scope of this dissertation. Most important, the S.E.C. has influenced the interpretation of the absolute priority rule in Chapter X reorganizations by its militant stand as expressed in numerous advisory reports. In many cases, the Commission's findings of unfairness and unfeasibility have been overridden by the courts, e.g., Flour Mills of America (60), and Green River Steel Corporation (73). Still, the S.E.C. is required to intervene in the public interest.

Objectionable features

The S.E.C. may reject proposed plans if they are either unfair or unfeasible, or both. The Commission has advised against the majority of the plans in the cases on which it has rendered advisory reports. Some of the main categories of unfair and inequitable treatment to which the S.E.C. has objected in disapproving one or more of the plans of reorganization offered will be discussed.

A moratorium on creditors' rights.- In the Penn Timber case, the Commission stated that the plan in effect would place a moratorium on the exercise of creditors' rights (4:4;630). It was said that both the plan's feasibility and fairness depended not only on the amounts to be realized from the sale of assets "but also on the time of such realization" (4:4;635). The first plan of reorganization was purported to be based on a theory of gradual liquidation. The Commission believed that the term may have been used by the reorganizers in the belief that "the principles governing ordinary plans of reorganization need not be observed in the case of liquidation" (4:4;634). The Commission felt that it was misleading to use the term in that case, since the debtor would continue operations similar to its operations of the past. The planned charter proposed to give the new corporation broad powers to acquire and exchange timberlands, to acquire and operate logging equipment, sawmills and factories, among other activities. The Commission said that the real effect was to give the debtor "a new lease on its old life; and not a mandate to terminate that life" (4:4;634). The Commission stated that it could find no support in the statutes or the decisions to the effect that a gradual liquidation was not governed by the same standards of fairness as other reorganizations (4:4;640).

Continued participation by junior interests when no equity remains.- The Commission has advised against continued participation when no equity exists for a particular class of security holder, e.g., Atlas Pipeline Corporation (51, p. 33). The valuation found by the S.E.C. may be inadequate for a particular class to participate, e.g., Deep Rock Oil Corporation (48, p. 19). A junior class may be able to participate unfairly because a senior class is inadequately compensated, e.g., Flour Mills of America (60, pp. 20-25). Or, junior interests may claim some additional advantages to the corporation by their participation (60, p. 26). Or, the amounts offered in payment for an equity may be inadequate for the value to be received, e.g., Northeastern Steel Corporation (74, p. 21).

Reduction of contractual claims and loss of status.- Under the absolute priority rule, all claims should be recognized as to their liquidation rights. To the creditors, this means that the full principal amount and accrued interest should be paid in actual asset value of cash and new securities. The Commission rejected proposed plans in several early cases involving reduction of principal amounts of claims while junior interests attempted to share in the reorganization, e.g., Penn Timber Company (4:4;630).

As to the reduction or cancellation of accrued interest or failure to provide the proper interest rate on the new securities, the Commission objected in several instances. It advised that the plan in the Flour Mills of America case was not fair in that the noteholders' claim of $2,906,033.25, including accrued interest, would be reduced to $2,661,000, and the interest rate on the new 4 per cent, 20-year subordinated income notes was a reduction from a 6-1/2 per cent rate

(60, p. 20). In the La France case, there would have been a definite loss of $146,250, or one-half of the back interest (49, pp. 15-16). In the Green River case, the plan proposed to eliminate all accumulated interest and to make the interest on the new debentures dependent on income and then non-cumulatively (73, pp. 1, 22). In the Atlas Pipeline case, the first mortgage bondholders would have been "required to take a reduction in interest from 6 per cent to 4-1/2 per cent" in addition to suffering considerable loss of status (51, p. 8).

Loss of status.- Loss of status as to the creditors may occur in five main ways. These are extension of maturities, elimination of protective features, change from fixed to contingent interest, alteration of redemption provisions, and subordination to new debt (109, p. 2). Loss of status may be necessary to create a conservative capital structure, but should be fully compensated. In early Chapter X cases, it was not too clear how loss of status was to be compensated. The usual means are increased participation in assets, earnings, or control (21). In any event, the Commission has refused to approve a number of plans of reorganization of industrials due, in part, to loss of status, e.g., Parker Petroleum Company, Inc. (56, pp. 1, 23-24).

Approved Plans

This section will be devoted to an examination of plans of reorganization approved by the S.E.C. for the purpose of determining what types of plans are approved, whether the plans are fair to security holders, and what general types of plans are most equitable to all interests.

Types of plans approved

Nine plans of reorganization of industrial corporations, of the twenty-five cases on which advisory reports were published between 1939 and 1963, were approved as to fairness and equity, and as to feasibility in the initial or a subsequent advisory report. Only five of these corporations were to be reorganized as going concerns. The other four cases provided for liquidation, either immediately or over a period of time. Liquidating plans generally have different standards for capital structures than plans for going concerns and these will be discussed in Chapter V.

Approved plans of reorganization will fall into two general classifications, depending on the degree of stratification of the new capital structure. These will be referred to as vertical plans and horizontal plans, terms which are attributed to Walter J. Blum (45, p. 597).

Vertical plans.- The general rule of absolute priority is that where the mortgage holders or the highest priority claim is satisfied, each succeeding class is to receive participation in descending order to the extent that any value remains. If each claim were to receive new securities which preserved the order of liquidation absolutely, the plan of reorganization could be termed a vertical plan. Perfectly vertical plans would be difficult to construct, but the plan which approached an almost perfect step-down in the new securities was that of The Higbee Company, which is shown in the chart on page 139. One additional new security would have been required to maintain liquidation priorities in the new corporation. The award to the junior debt holder represented something of a compromise, since the amount of the allowable claim was in contention. It was asserted that the award could not "be

PROPOSED DISTRIBUTION OF SECURITIES
THE HIGBEE COMPANY

	Present Capitalization	Treatment Under Plan					
		Cash	Serial 4% notes	7-year 4% notes	10-year 4% notes	5% Cumulative preferred $100 par	Common Stock $1 par Shares
Senior Bank Debt	$ 591,931.	$ 150,000.	$ 441,931.				
Senior Rent Debt	846,922.			$846,922.			
Junior Debt	1,951,728.				$ 600,000.		13,517
1st Preferred Stock:							
Principal	1,139,900.					$ 1,139,900.	
Dividend	738,085.					246,000.	4,921
2nd Preferred Stock:							
Principal	452,100.						
Dividend	331,538.						7,836
Common Stock	100,000.						
	$ 6,152,203.	$150,000.	$ 441,931.	$846,922.	$ 600,000.	$ 1,385,900.	26,274

(69,p. 9).

said to be unfair, assuming that adequate treatment has been provided for the preferred stock" (69, p. 24). Treatment of two-thirds of the accumulated dividends of the first preferred represented a quantitative step-up for a qualitative loss. It is possible that under a vertical plan, claimants may receive two or more new securities in satisfaction of claims.

Horizontal plans.- A perfectly horizontal plan would be one in which a single issue of new securities is divided "between the juniors and seniors" (45, p. 597). Most horizontal plans of reorganization importantly affect only one or two classes of security holders. However, the possible effect on the value of the award to these classes may be large. Perfectly horizontal plans would be advantageous only if they could provide a degree of participation to all old interests. Perfectly horizontal plans, however, would have certain limitations from the standpoint of fairness. The valuation would have to be highly accurate, otherwise participation granted to senior interests would be at the expense of junior interests, or vice versa. Furthermore, either later financing or fluctuations in common stock value could subject all interests to uncertainty as to the value of their claims. Horizontal plans also prevent any possible advantage from having prior securities in the capital structure.

Intermediate type plans.- An example of a type of plan intermediate to the vertical and horizontal plans was that approved in the Childs Company case (65, p. 3). The holders of the old preferred stock would receive 100 per cent of the new preferred stock and 57.99 per cent of the new common stock and the holders of the old common stock would receive 42.01 per cent of the new common stock. In such a plan,

the valuation figure which determines the proportions of common stock to be issued each class is highly critical.

This was the situation in the Sayre & Fisher Brick Company case (59, pp. 4-5). The unsecured creditors, who were to receive 1 per cent of the common stock for claims totaling $278,327, were affected most seriously by the plan. Recognition of the claims of preferred stock at $2,949,500 would have required a valuation at least 25 per cent higher than the $1,100,000 valuation found. The Commission capitalized earnings of $100,000 at 12 per cent to produce an $830,000 valuation for earning assets. A 10 per cent rate would have provided $170,000 more common stock equity and would have satisfied over 60 per cent of the claims of the unsecured creditors. This would have paid them most of their principal, but none of their interest, in new common stock. The old bondholders would still have retained the controlling interest in the corporation.

Professor Blum is not concerned with the intermediate type of plan explained herein, nor with another intermediate case. This special case is where only one class of security holder retains an interest in the new corporation, but the class received more than one new security. This will happen under the absolute priority rule in every case in which the first mortgage holders take over the corporation and at least one prior security is issued, since common stock must always be issued.

Specific plans approved.- A first approach to an examination of the types of plans approved may be made by comparing the approved debt ratios and combined debt and preferred stock ratios to the approved valuations. The maximum debt ratio approved for an internal reorganization was 48 per cent for the Minnesota and Ontario Paper Company (50,

pp. 81-82). In all other cases examined, the highest ratio approved for an internal reorganization was 30 per cent for The Higbee Company (69, pp. 5-6). Other approved ratios were 19 per cent in the McKesson & Robbins case (58, pp. 19, 24), and 15 per cent in the Childs Company case (65, p. 4).

Preferred stock may be the senior security although there is usually long term debt ahead of it. The highest ratios of debt and preferred stock to valuation were The Higbee Company at 53 per cent (69, p. 9), the Childs Company at 51 per cent (65, p. 3), and McKesson & Robbins, Inc. at 29 per cent (58, pp. 18-19). In some cases, no preferred stock was authorized, even though there were debt securities, e.g., Minnesota and Ontario Paper Company (50, p. 77).

There were many disapproved plans in which the quantity of proposed debt and/or preferred stock was less than some of the approved ratios. In some of these cases, the Commission recommended all common stock capitalizations. These cases will be discussed in Chapter V.

Fairness to security holders

There has been some concern that the absolute priority rule may be regularly violated as to the senior interests (97, p. 900). The criticism turns on the fact that senior claimants are not given exactly the same security qualitatively, or that qualitative losses are not precisely compensated. This unsigned article deals mainly with fairness related to the distribution of securities for the valuation found.

Fairness at the time of reorganization.- Once a valuation amount is decided upon, the distribution of new securities must be matched against that valuation. In this procedure, unfairness between classes of security holders may result by failure to observe legal

rights, thereby transferring value to other classes of security holders. Unfairness of this type is not the subject of this dissertation, but an examination of the industrial reorganization cases revealed evidence of an important possible violation of the absolute priority rights of senior security holders in only one case.

Loss of part of principal while junior interests were permitted to share may have occurred in the Detroit International Bridge case (110, pp. 1-7). Since insolvency was apparent, no overall valuation was made. The reorganized company was to have a capitalization of $217,175, consisting of 217,175 shares of $1 par value common stock. Of this, 207,648 shares were to be issued on the basis of 16 shares for each $1,000 bond and 2 shares for each $1,000 debenture.

The S.E.C. permitted the participation to the juniors (debenture holders) based on the fact that the stock of the Canadian subsidiary was pledged to secure the debentures and that under Canadian law, a reorganization of the Canadian company would require expensive foreclosure proceedings. It was said to be desirable to preserve the Canadian company by securing "the cooperation of the debenture holders" (110, p. 6). The Commission felt that receipt of 7.7 per cent of the new stock by the debenture holders was not an unreasonable settlement of their claims, since the indenture trustee had failed to impound the cash for the entire benefit of the bondholders, upon default on the bonds. A provision was made in the reorganization plan reserving to the bondholders any rights against the indenture trustee. The latter served in that capacity for both the bonds and debentures, so the possibility of conflict in his legal obligations had arisen. In addition, the protective committee for the bonds had failed to take action to

impound the cash.

Both the law and the authorities seem to operate in a manner designed to satisfy the most senior claim. The law requires that the face amounts of securities surrendered be fully compensated with new securities which are equal in value to the old. On balance, it appears that the S.E.C. has made every reasonable effort to adequately compensate senior interests in every case with the possible exception of the above mentioned early Detroit International Bridge case (110). It should be noted that when the senior security is presumed to be satisfied, the class immediately below it will become the senior class for the purpose of distributing value. As much diligence should be exercised in testing the fairness and equity of the plan to the next lower class as to the most senior class. This requirement was established by the precedent cases.

Diligent efforts to provide full compensation to senior claims may be at the expense of junior claims. The award to junior claims will often be all common stock, which makes the value of the award highly variable, depending on the valuation found and the percentage of claim which is satisfied. A tendency, found in some cases, to issue a generous nominal quantity of common stock, available from a given valuation, to the highest priority claimants may result in gross inequity to excluded or partially excluded junior interests. In addition, junior debt may require qualitative reductions at least as great as those required for senior debt, thereby necessitating even greater quantities of common stock to be awarded to classes above the most junior claims. Recognition of the involuntary liquidation rights of the preferred stock may partially or totally eliminate the old common stock

from participation.

The procedure of quantitative gain for qualitative loss causes the impact of any one possible valuation over another to be quite great on the junior securities. This effect is demonstrated by the distribution of new securities in the McKesson & Robbins case (58, p. 19). Aside from the very minor priority claims which were paid in cash, all other creditors' claims were placed on a parity and received awards of cash and new debentures, plus 20 per cent of their claim in new 5-1/2 per cent preferred stock. This forced the old Preference Stock, $3 series, stated value $50, to accept compensation consisting entirely of common stock. Preferential status was lost, both as to earnings and assets, since the security was placed on a parity with old common stock. The Commission said that preferreds' participation in control through 81 per cent of the voting power and a highly satisfactory earnings coverage would be fully compensating (52, p. 25). The new shares had a par value of $18.00, but an asset value of approximately $26.00 per share, based on the residual portion of the valuation. The Commission computed the expected earnings attributable to the new common stock at an average of $5 for each 2.3 shares of new common to be received for each old Preference share. Thus Preference stock received a 40 per cent larger claim on assets (2.3 x $26. = $69.80, compared with $50 stated value) and an indefinite but probable 67 per cent larger claim on earnings ($5 compared with $3), plus control of the reorganized company. Possibly the quantitative step-up for the Preference stockholders was too large for the qualitative sacrifice. The old common stock received only 19 per cent of the new common stock.

Fairness after reorganization.- It was established in Knight v.

Wertheim that creditors have no legally protected right above the amount of the principal and accrued interest (111). The precedent cases established that fairness requires the same attention to the value of awards between classes of creditors, and between classes of stockholders, as between senior creditors and stockholders. It is posited that the award of value to one class that belongs to another class by the valuation found is a violation of the absolute priority rule. The Commission cannot be held under present law or as a practical matter to a correct valuation. However, measures should be adopted to minimize the possibility of inequity resulting from incorrect valuation.

Errors in valuation are of no great consequence to the seniors in the case of a finding of insolvency. Errors in valuation are not serious to the holders of senior securities in a finding of solvency, if these securities are replaced with new securities with fixed income and liquidation rights. Often, the new securities will be as strong as the securities they will replace, and they may be protected in many ways not normal to going concerns.

A low valuation will overaward senior interests, since juniors who should have been entitled to participate are eliminated. A high valuation will overaward junior interests since they receive value which should have been awarded to senior interests. The effects of incorrect valuations are minimized in vertical plans as opposed to horizontal plans. The effects of a low valuation on each class of security holder may be demonstrated by the plan in The Higbee Company case (69, pp. 5-9). This plan may be regarded as a vertical plan, except for the awards of common stock to the three junior classes. Thus, the effect of the incorrect valuation involved mainly the old junior debt and two

classes of old preferred stock and, possibly, the old common stock, which was completely eliminated from the plan.

Under the plan, the holders of the 7 per cent cumulative first preferred stock were to receive new 5 per cent preferred stock for the principal amount of their claims and for one-third of their accumulated dividends. For the balance of their accumulated dividends, they were to receive new common stock representing as much as 110 per cent of the principal amount of that portion of their claims. The subordination under the Deep Rock doctrine of the junior debt made it possible for the first preferred stock to receive something other than common stock (69, pp. 21-24). Additional debt of as much as $1,500,000 would have placed the preferred at the same level of priority as the most junior security included in the plan. If the litigation then under way were to completely subordinate the junior debt or limit it to $100,000, then the first preferred shareholders could have received as much as $600,000 additional in securities similar to those held toward satisfying their claims.

A similar situation existed with respect to the 8 per cent cumulative second preferred stock. The Commission stated that the second preferred stock "in a sense represents the residual claim in this case, since the common stock does not participate as such under the plan" (69, p. 27). The Commission is under no obligation to find a value for the residual claim, however, it was stated that "the new common stock will represent an asset value in excess of the rate at which it will be allocated to the Second Preferred Stockholders" (69, p. 27).

In the plan, the second preferred received 32 per cent of the

common stock, while the first preferred received 17 per cent and the old junior debt received 51 per cent. If the valuation of $6,152,203, proposed by the plan, were the correct valuation, at least full compensation was accorded all classes of creditors and stockholders who were to participate, but not to the old common stock.

The ultimate effect of the market price test on the value of securities awarded, in later years, is quite interesting. The senior bank indebtedness of $591,931 had been compensated at the time of reorganization with cash and new notes. The notes were paid off in 1942, well ahead of their four-year serially scheduled maturities (112, p. 608). The senior rent indebtedness of $846,922 had been compensated with new notes and the balance of these were retired in April, 1943. The remaining claims which were of interest from the standpoint of equitable distribution several years after reorganization were the old junior indebtedness, the old first preferred stock, and the old second preferred stock. The actual market value of these claims could not be determined prior to 1943 due to the absence of a market quotation on the new common stock, which comprised part of the compensation of each of these three classes of claimants. Quotations for the $5 preferred were available immediately, as shown by the following:

Market Price Quotations for $5 Preferred Stock (Bid prices for year) The Higbee Company

1942	47 - - - 62
1943	49 - - - 84
1944	85 - - - 98-1/2
1945	98-1/2 - - - 100
1946	98 - - - 101
1947	100-1/2 - - - 101
1948	100 - - - 102
1949	97-1/2 - - - 100

(86, p. a50).

The $5 cumulative preferred remained within a point or two of par until redeemed on November 1, 1955 at $101.25 a share. In 1943, the common stock was quoted at 60-65 bid, and by 1944 had reached a price level which would have resulted in full compensation to each class holding common stock, if the stock had been sold in the market. By 1946, the old first preferred's original claim of $1,877,985 was "worth" approximately $3,846,400, or over 205 per cent of the original claim. By 1946, the second preferred's original claim of $783,637 was "worth" $3,918,000 in the market place, or approximately 500 per cent of the original claim. Thus, the weakest claim received the greatest benefit from the distribution of securities, entirely common stock, the second weakest claim received the next greatest benefit, and the most secure claim, the first preferred, received the smallest benefit. However, all these classes fared well within four years after reorganization.

The only remaining claim, the eliminated common stock, had been valueless for years. It had passed through several hands associated with the old Van Sweringen empire along with the junior debt which was subordinated under the Deep Rock doctrine (69, pp. 21-24). The difficult question of law as to whether it should have received participation cannot be answered herein. In any event, Bradley and Murphy, who held both the old junior debt and the old common stock, were fully compensated as to the face amount of their claims and as to the amount they had paid for them.

The Childs Company case represents the effect of an intermediate type plan where the value decreased after reorganization. In this case, the claim of the old debentures were to be paid in cash in full, and approximately $1,600,000 in mortgages were to be assumed by the new

company, so the creditors were said to be treated fairly (65, pp. 4-5). A number of plans were proposed, but the plan which was finally approved called for $3,731,600 of 5-1/2 per cent cumulative preferred stock and 772,207 shares of common stock. Old preferred stockholders with claims of $7,845,000 would receive the new preferred stock and 57.99 per cent of the common stock. The Commission concluded that liquidation preference set forth in the charter, rather than the 7 per cent dividend and the noncallable feature, controlled the value of the award. Hence, the new preferred stock carried a 5-1/2 per cent dividend and was callable at par for five years. The new common stock awarded to the old preferred shareholders represented an asset value approximately equal to the accumulated dividends.

The last year in which the capital structure was somewhat the same as at the time of reorganization was 1949. During that year the new preferred stock sold between 60 and 35, and the new common stock sold between 5-1/8 and 2-1/8, compared with reorganization values of 100 and 8-1/2 for the new preferred and common stock, respectively. The effect of the intermediate type plan in this case was to make the old preferred claims highly vulnerable to fluctuations in common stock prices.

The most equitable plan

The most equitable plan should be one which achieves the greatest degree of fairness at the time of reorganization and at a later date. The vertical plan appears to provide the greatest degree of fairness at the time of reorganization in that it provides old security holders with new securities most like those they relinquish. The vertical plan, also, appears to provide the greatest degree of fairness in

later years in that it permits each old security to realize an amount close to the value of its old claim either through redemption by the corporation or by sale of the securities in the market. However, carried to its logical conclusion, the vertical plan should contain at least one additional security in order to preserve the order of priority absolutely. If only two old securities were outstanding, a model vertical plan could award the senior security holders all common stock and award the junior security holders warrants to purchase that stock at the value placed on the stock at the time of reorganization as market price increased (45, pp. 597-598).

Although fairness does not require that value be found for junior interests, fairness does not permit value to be awarded to seniors which should have belonged to juniors. It is most appropriate that only the most junior claim should receive an award of highly variable amount, although some speculation is necessary at the lower end of any vertical plan. Ideally, one additional security such as a warrant, would not only preserve the order of priority as far as possible but would also place speculation on change in value at a more appropriate level. Speculation at the common stock level, where claims are presumed to be fully compensated, exists in both vertical and intermediate plans, as well as under horizontal plans as presently established.

Conclusions on approved plans

It appears that when value is found to permit junior interests to share in the plan that their rights in some cases may not be protected as diligently as those of senior interests. The Commission may judge the strength of the claim in relation to others, rather than a favorable contract, as ruling to an extent. Most approved plans of

reorganization are reasonably fair to all senior interests, and to junior interests who participate in the plan. However, at least part of the favorable degree of fairness to senior and to participating junior interests may be achieved at the expense of the more junior interests. Aside from being excluded by the valuation, the greatest likelihood of inequity to junior interests is the reduction in their proportionate claims on new assets and income.

The Securities and Exchange Commission seems to desire that reorganized companies have an opportunity to demonstrate profitability. It may provide them with the kinds of capital structures which will minimize financial failure in case they do not become profitable. However, it has not demonstrated that it provides the strongest possible securities in the largest feasible amount to each claim, or that it creates an optimum capital structure in terms of types or numbers of securities. The effect of financial structure on total valuation will be analyzed in Chapter V.

CHAPTER V

FINANCIAL TESTS OF PLANS OF REORGANIZATION

The Securities and Exchange Commission, in its advisory role under Chapter X, has quite properly taken the position that evaluation of the corporation in reorganization must be made in order to test the fairness and feasibility of the proposed plan or plans of reorganization. Such evaluation is in fact indispensable if the absolute priority rule is to be applied. After examining the factors influencing the value of the enterprise, the Commission has usually in its advisory opinions indicated some one "best estimate" as the exact or, in some cases, the maximum value of the corporation. Thus, a definite value of the corporation is established and made the basis for applying the standards of fairness and feasibility to the plan of reorganization.

The purpose of this chapter is to analyze possible modifications in the methods of and approaches to the evaluation of corporations in reorganization currently used by the Commission. If these modifications are defensible and if their use would give different valuations for the corporation in reorganization, then in some cases clearly a different plan of reorganization could be declared fair and feasible. Specifically, if a higher valuation were determined, some groups of claimants excluded from participation by a proposed plan might well be allowed to participate and in other cases groups which have been allowed to participate to a limited extent might receive additional compensation.

The applicability of the absolute priority rule is not here being questioned. Nor, indeed, is the Commission's basic approach to the valuation of a corporation as a going concern, namely, the capitalization of anticipated earnings. It is possible, however, to use this general approach, but to make modifications in details which would give different valuations. This chapter is thus concerned with some of these possible modifications.

These modifications include: (a) the adoption by the S.E.C. of the so-called philosophy of expansible value approach which the I.C.C. has seemed to follow in the reorganizations of some railroads both under Section 77 and under the less stringent adjustment procedures, (b) the awarding of securities in the plan of reorganization in accordance with the investment value rather than the liquidating value of the old securities, an approach which has been used by the S.E.C. in the Public Utility Holding Company Act reorganizations, (c) valuations derived by capitalizing earnings necessary for bond interest at one rate and earnings available for equity at another higher rate rather than capitalizing all earnings at the same rate, (d) a greater acknowledgment of the difference in the impact of the corporate income tax on earnings paid out as interest and earnings in excess of this amount and hence on the difference in valuation produced by differing capital structures, (e) a clearer understanding of the factors which may limit the quantity of debt in capital structures of reorganized corporations, (f) a clearer understanding of the factors which may limit the variety and quantity of securities in capital structures of reorganized corporations, and (g) an approach to the development of an optimum capital structure for the corporation emerging from a Chapter X reorganization.

Expansible Value

The Interstate Commerce Commission, in Section 77 reorganizations, implicitly employs a limited expansible value approach according to Walter J. Blum (98, p. 440).

The meaning of expansible value

The meaning of the expansible value approach is that priorities are maintained and full compensation is achieved through the creation of "a hierarchy of new securities that would take on value in descending order as the earnings or prospects of the enterprise improved" (98, p. 437). Such an approach has possible implications for Chapter X reorganization, since Section 77 reorganization is generally considered to be the railroad counterpart of industrial reorganization under Chapter X.

In employing this approach, the I.C.C. determines a maximum permissible capitalization as the upper limit to the amount of new securities which may be issued. According to Blum, the technique followed by the I.C.C. in Section 77 cases is to determine "how large a capitalization can be supported by the estimated earnings" (45, p. 573, n. 11). From the estimate of earnings and the "capitalization," the rate of capitalization is derived indirectly.

Under such plans of reorganization, it is contemplated that the railroad corporation will eventually have value higher than its depressed reorganization value. In the choice of a total capitalization and, consequently, a present valuation, there is an understanding that the present market value of securities is below the underlying economic value of the assets, partially due to the present physical condition of the railroad property. Most railroads were in such a poor state of

maintenance that part of the estimated future income would need to be diverted to additions and betterments for some time to bring the railroad up to its long term economic value. Since the long term economic value of the property is the target to which market values are expected to expand, there is a definite upper limit to the amount of new securities which will be authorized. Under successful Section 77 plans, full value is usually achieved immediately by the new fixed income bonds, and after some period of time by contingent income securities and common stock. Since the principle of full compensation requires compensation for loss of priority position, for loss of principal amount of bond and for loss of accrued interest, no junior security may participate until the senior security is fully compensated. In practice, this usually means that old stock interests are wiped out, since the amount of new bonds issued is usually a fraction of the amount of the old bonds. However, according to Blum, use of the approach tends to "keep in the reorganized company a junior class (or classes) which would have been eliminated" (98, p. 439). This is because such interests will be eliminated only if there is no remote possibility of finding an equity for them. This is possible under the precedent case law applying to railroad reorganization.

Section 77 case law
and its application

In Chapter II, the fact was discussed that certain legal precedents permit the I.C.C. to apply a more liberal and flexible standard than the S.E.C. under Chapter X. The present interest is in the specific application under Section 77 of some of the rulings of those cases.

The ability of the Interstate Commerce Commission to preserve priorities without the prior determination of specific dollar valuations of the specific assets or the whole properties was established in the Milwaukee case (39, p. 730). Such a concept of valuation permitted the I.C.C. to utilize the anticipated earnings to establish the quantity of securities of different types which would be feasible. The valuation is equivalent to this quantity of securities, or capitalization. Under the ruling, earning power was still the proper criterion for establishment of the capitalization, but "consideration was also given to original cost, cost of reproduction new and actual investment" (39, p. 727). It appears that the I.C.C.'s ability to give some weight to actual investment in property, as well as original cost and cost of reproduction new may permit a somewhat more liberal rate of capitalizing projected earnings than is found in Chapter X reorganizations. According to Kenneth Field, the Interstate Commerce Commission had approved capitalizations which capitalized normal earnings at rates from 1.4 per cent to 4.28 per cent, in early railroad cases (113, p. 1522). Later rates of capitalization are a little higher than these.

The Milwaukee case established that the I.C.C. is required only to find probable earnings sufficient to service the debt as to interest and principal and to leave some surplus for the stock. A decision as to debt ratios and as to fixed, as opposed to contingent, interest was held to be entirely within the discretion of the I.C.C. The decision said that it is proper to create a new hierarchical capitalization in order to preserve priority. The opinion reads, in part, as follows:

> In railroad reorganization proceedings, it is sufficient that each security holder, in order of his priority, receives from what is available for satisfaction of his claim the

> equitable equivalent of rights surrendered, and, in making such allocation, a comparison of new securities allotted to him with old securities which he exchanges is necessary, but that determination cannot be made by use of any mathematical formula (39, p. 731).

In the companion Western Pacific case, the Supreme Court said that the appropriate final quantity of securities is properly left in the hands of the I.C.C. (38, p. 692).

Professor Blum concludes that the I.C.C. "has not articulated any one approach to achieving full compensation" (98, p. 440). It leans strongly, however, toward plans which are based on optimistic earnings forecasts, uses a hierarchy of new securities, and attempts to maintain the relative priorities of the old securities. In a complete application of the expansible value approach, the I.C.C. would presumably start with the problem of feasibility and proceed to the problem of fairness. The maximum quantity of fixed charges which could be reasonably supported, based on the forecast of expected earnings, would be first determined. After the amount of fixed charge securities which could feasibly be issued was determined, attention would then turn to the contingent charge securities and finally to the common equity. Utilization of the method could most easily be accomplished by award of the largest feasible "quantity of paper." This would mean a variety of securities to include income bonds, preferred stock, junior common stock, and stock purchase warrants. Under the Milwaukee ruling, it is clear that contingent income securities are not disfavored (39, p. 731). In the companion Western Pacific case, it was said that after all reasonable value has been exhausted in railroad reorganizations by the issuance of new prior securities, warrants could be issued on the possibility that some value might remain, but such presently valueless

warrants are not a requirement of plans of railroad reorganization (38, p. 693).

Section 77, like 77B, contains the requirements of fairness and equity, but according to Hand and Cummings, these two principal railroad reorganization decisions required a less stringent standard than that of the Los Angeles Lumber case (114, p. 976). Despite even the liberal approach which permitted new first mortgage bonds, income bonds, preferred stock, and common stock in the Western Pacific case, value may be so deficient that only senior creditors may share. The capital structure of the companion Milwaukee case included two new classes of income bonds and a noncumulative preferred stock, and, still, the old stockholders were eliminated.

Applicability of expansible value approach under financial readjustment acts

Financial readjustments of railroad corporations are legally not the same as complete reorganization of railroads. However, brief attention will be given to the rights of security holders under these acts. Between 1939 and 1945, the railroads were allowed to secure voluntary extensions under Chapter XV of the Bankruptcy Act (1:53;1134). This Chapter was designed for "readjustment of obligation-type securities of railroads in temporary financial difficulties" (114, p. 977). The standard of the Chapter was "fair and equitable as an adjustment," but the exact nature of the standard was not made clear, nor was the act widely used.

In 1948, due to the rather expensive and time consuming procedures of Section 77, Section 20b, known as the Mahaffie Act, or the Railroad Modification Act, was added to the Interstate Commerce Act (1:

62;163). This law provided for composition type adjustments of any class of debt. Section 20b is not designed as a substitute for Section 77, but rather to provide relief in those cases in which the more drastic measures of Section 77 may properly be avoided.

According to Wren, under Section 20b, as under Section 77 of the Bankruptcy Act, the I.C.C. first considers the problem of feasibility (115, p. 716). The task in any railroad reorganization is to set up a financial structure which will be able to withstand periods of financial difficulty. This means maintaining proper ratios between debt and equity and between fixed charges and income. It means appropriate spacing of maturities, provision for sinking funds for special retirement provisions and for clauses in bond indentures permitting the extension of maturities. The term "fair and equitable" does not appear in Section 20b. Instead "just and reasonable" and "best interests" of security holders provide for "fairness," while "public interest" and "best interest of the carrier" provide for "feasibility."

The I.C.C.'s approach to fairness is about the same under Section 20b as under Section 77, except that strict liquidation preferences of junior interests are not observed under Section 20b. While the "best interests" and "just and reasonable" language of Section 20b would seem to be different from the "fair and equitable" language of Section 77, the I.C.C.'s approach to the problem has been "largely the same as that used in Section 77 cases" (115, p. 739). This means essentially full compensation to senior debt interests. The main distinction will be in the amount of the claim to be recognized. Feasibility standards would be the same under the two sections, and should include the appropriate debt to equity ratios, earnings coverage and

spacing of maturities.

Difference in reorganization setting

The I.C.C., in contrast to the S.E.C., has complete control of the plan of reorganization. The public interest requires that the railroads continue to operate, whereas many industrial reorganizations are liquidating plans. In railroad reorganizations, there appears to be an interest in preserving weak claims, even the old common stock, whenever possible, although full compensation for loss of priority by the senior classes is still rigidly required. Although the fairness and equity standard of Section 77 is the same as that of Chapter X, the former is legally applied less severely than the latter. The I.C.C. is charged with the responsibility of seeing that the public interest be served by the construction of plans of reorganization so designed that the railroad will not return to the courts at some future date. At the same time, the I.C.C. must recognize the relative priorities of numerous claims (39, pp. 730-731). These conflicting goals may best be accomplished by a hierarchical capital structure. In order to accomplish this kind of capital structure, valuation must focus on claims on income rather than on asset value, although a relatively large original investment or reproduction cost of assets might permit a liberal interpretation of the earnings requirements. It seems clear that the liberal use of contingent income securities, including warrants, plus the much lower rates at which earnings are capitalized, permits higher valuations for the same quantities of earnings than would be the case for reorganizations of industrial firms.

However, it is also clear that under both the I.C.C. and the S.E.C., the full value of senior claims is recognized on an earnings

basis. It has been said that bondholders' claims are measured the same in all reorganization contexts (116, p. 682). Yet, when the kinds of junior securities which are awarded are examined, there is a difference in the practices of the two Commissions. The I.C.C. is much more likely to provide for generous quantities of contingent income securities in the plans. The S.E.C., on the other hand, must be assured that contingent claims on income will be fully met within a short time. In each reorganization context, the ultimate liquidation rights of new securities are comparable.

Legal precedent for Chapter X.- The expansible value approach as practiced by the I.C.C. has little case law precedent for Chapter X reorganization. A more pragmatic treatment of interstate railroad securities was apparently intended by the Supreme Court in the Western Pacific and the Milwaukee cases. However, both cases reiterated the requirements for a fair and equitable reorganization. Precedent cases for both Section 77 and Chapter X emphasize the earning power requirement, but leave open the exact participation and compensation. It is suggested that the S.E.C. may impose a more Spartan method than required by the precedent cases or the statutes.

It should be recalled that interstate railroads, insurance, banking, building and loan, and municipal corporations are excluded from Chapter X reorganizations. Consequently, insolvent public utilities, such as water, gas, and electric companies, and insolvent intrastate railroads may be reorganized under Chapter X. There is no indication from the cursory investigation made of some of these cases that the S.E.C. is legally required to support plans designed to preserve the corporation in the public interest, even though it is a public

service corporation. For example, the Inland Gas Corporation was part of the Columbia Gas System and its rates for selling gas were set by regulatory agencies. The S.E.C. based the earning power valuation of Inland on an estimated economic life of 25 years (4:38;347-348). The 10 per cent rate of discount used for the earnings of Inland indicate no obvious departure from the philosophy of the Commission as to rates of discount for industrial corporations, nor was there indicated any desire to preserve the company indefinitely.

Chapter X similarities to expansible value.- In cases in which the rates of capitalization are established only after earnings and total capitalization are determined, a similarity to the expansible value approach would exist. In the two cases in which the lowest rates were selected, the Commission actually derived rates of capitalization which, when divided into the adjusted earnings estimates, would reproduce the valuations recommended by the trustees (69, p. 20) (58, p. 17). The derived rates of capitalization of before-tax earnings of 8.7 per cent for McKesson & Robbins, and 9.8 per cent for The Higbee Company, suggest that the S.E.C. could have dispensed with this step except for the need to demonstrate that the earnings produced a fair capitalized value. A more customary rate, such as 9 per cent or 10 per cent, would have been consistent with the S.E.C.'s action in other cases. Variations in value, due to derived rates as opposed to more customary rates of capitalization, are important only if some claim is marginal, as was the situation for The Higbee Company. As stated earlier, The Higbee Company case, and several others, called for a rapid payoff of debt. These cases possess a similarity to one other aspect of expansible value in that junior interests' securities would increase in value as their

claims on income became more certain. The Higbee Company case had at least one other characteristic of an expansible value approach. The adopted plan called for a somewhat hierarchical capital structure, however, maximum use of debt securities was not a feature of the plan.

Another Chapter X case which was quite similar to the expansible value approach of the I.C.C. was that of the Keeshin Freight Lines, Incorporated (85). By the capitalization of earnings method, a valuation of $2,200,000 was made, thereby avoiding a sale at an upset price of "not more than $1,335,000," which would have been deficient as to the debt (85, pp. 18-19). Dividends were to be deferred for five years on the second preferred and common stock while the debt was being reduced. The case was quite similar to expansible value in that the proposed hierarchical capital structure called for five classes of debt securities and two classes of preferred stock, in addition to common stock. The Commission approved this structure, with a reservation that it was initially top-heavy, but disapproved a feature of the plan related to future capital outlays (85, pp. 23-25). The 15 per cent rate of capitalization of after-tax earnings was several hundred per cent of the rates usually applied to railroads. Furthermore, such a high rate would also produce a very high earnings coverage for the debt and even the preferred stock. The Commission found the Keeshin-Ratner plan to be feasible, but "narrowly so" (85, p. 1). This plan, which was the proposed plan favored by the S.E.C., was not approved as to fairness because of alleged loss of status as to creditors (85, p. 20).

In the Sayre & Fisher Brick Company case, the plan proposed by two bondholder committees called for a capitalization of $268,430 par value of preferred stock and $542,760 par value of common stock, with

any difference between this $811,190 total, and the valuation approved by the court to be in the form of initial capital surplus. In advising a reorganization value not to exceed $1,100,000, the Commission said the amount was "the maximum which may reasonably be found" (59, p. 10). This may seem like the "maximum permissible capitalization" utilized by the I.C.C. However, throughout the Chapter X reports, the impression is given that the S.E.C. considers the maximum value and maximum permissible capitalization to be the same thing as the estimate of valuation which it finds.

The Commission has made few efforts to preserve claims, as the I.C.C. has, by the generous award of "paper claims." The S.E.C. approved the use of warrants in only one early industrial case (110, p. 5). However, the S.E.C. appears to have a slightly different attitude in its intrastate railway cases. In the Hudson & Manhattan Railroad case, the S.E.C. permitted two classes of new common stock, because the possibility was foreseen of some participation by the junior bondholders within four years if some public agency were to buy the property (4:38; 710). Such a liberal interpretation of the possibility of value existing for junior interests in insolvent situations has not held for Chapter X industrial reorganizations.

Conclusions

From a detailed perusal of the literature it appears that the main reason the I.C.C. and the S.E.C. may apply somewhat different standards is due to the efforts of the two Commissions to have their own views on the applicable administrative law accepted by the courts. To a great extent the two Commissions converge in the adoption of certain aspects of valuation in some cases. For example, under Chapter X

the S.E.C. has approved hierarchical financial structures in a few cases and has built into the plans certain provisions for the retirement of new prior securities over time, thereby finding value for junior securities. However, the S.E.C. does not authorize securities whose claims on earnings and expected market prices would be expected to be deficient for any extended period, as in the Section 77 reorganizations. In effect, the S.E.C. applies the liquidation standard as of the present time to all securities, even participating common stock claims, whereas, the I.C.C. applies the liquidation standard in the order of priority, but over a period of time. It appears that each approach is appropriate to the extent that the courts agree with them. Consequently, the expansible value approach has little implication for Chapter X, unless the S.E.C. were to press for its adoption.

Investment Value

It is possible that the award of securities in accordance with investment values rather than liquidating values may produce a different valuation from one determined by the capitalization of earnings and that such different valuation could effect the participation by claimants in the plan of reorganization. Investment value as used in reorganization means that claims, particularly those of stockholders, are measured and compensated on a going concern basis rather than a liquidating basis. Justification for the use of the approach is to be found in the rulings regarding the intent of Congress, in passing the various acts relating to reorganization, as to whether or not contracts should be accelerated and matured by the filing of a petition. Since petitions under Chapter X accelerate and mature contracts, the investment value approach has

little current legal applicability under Chapter X, except in a limited manner which will be discussed at a later point.

Investment value has been described with various terms such as current worth, equitable equivalent, and economic value, as well as going concern value. The term investment value will be explained as it is used under different reorganization circumstances.

Securities to which applied

The investment value approach is important in that it applies a different standard to various securities in contrast to the single liquidation standard for all securities of the absolute priority rule. Recognition of the new investment features of junior securities, rather than their liquidation features may increase the total valuation of the corporation, if the junior interests tend to value the investment features of their new securities more than their liquidation features, and if this is the basis of the exchange of securities in reorganization.

In an unsigned article in the Yale Law Journal, it was said that "in all reorganization contexts bondholder claims are measured alike. Since earnings potential is the primary guage of economic worth, investment value analysis of bonds stresses the worth of old income rights to guide allocation of new securities" (116, p. 682). It was further stated that "in contrast to uniformly applied bond measurement criteria, yardsticks for measurement of stockholder claims vary with reorganization settings" (116, p. 683). Under Chapter X, and possibly under Section 77, preferred stock is considered matured as to liquidation rights, whereas, under the Public Utility Holding Company Act and under Section 20b of the Interstate Commerce Act, liquidation rights are only a minor factor in determining full compensation. According to Walter J. Blum,

even in the P.U.H.C. cases, the S.E.C. "seems to regard the principal amount of an indebtedness as a floor, at least where the debt-holders are being paid off in cash" (98, p. 428).

In the cases of the financial readjustment, the tendency to observe creditors' rights is shown by the following reference to the requirements of Section 20b:

> Properly, the principle of full compensation in the order of contractual priority requires only that the investor be given new securities roughly equivalent to the "full bundle of rights" or the "investment value", of his old investment. In the case of bonds, this "equitable equivalent" includes compensation for the loss of any priority rights, as well as the sacrifice of any principal or interest claims (115, p. 737).

Investment value under the Public Utility Holding Company Act

Investment value as used by the S.E.C. under Section 11 of the Public Utility Holding Company Act has a rather specialized meaning and is the usual source of reference to the investment value doctrine in the literature (1:49;820). According to Donald A. Fergusson, "in this area, so-called 'immediately operative' rights, such as rights to earnings and dividends, as opposed to 'inchoate' rights such as liquidation and redemption preferences, have been given primary weight in evaluating the bundle of rights making up the stock contract" (117, p. 52).

Although the term fair and equitable was used in Section 11 of the P.U.H.C. Act, its use was said to be "rather unfortunate" because of the later legal controversy (117, p. 50). In the early holding company simplification cases, the S.E.C. applied the liquidation standard of the absolute priority rule. But very shortly, in the United Light case, the S.E.C. shifted from liquidation preferences for preferred stock to "legitimate investment values" and was upheld by the Supreme

Court (44). The investment value doctrine was held to apply in solvent public utility cases whether simplification was by liquidation, merger, or recapitalization. Investment value in this sense means present going concern value of the old claims, or current worth as investments. In the case of Schwabacher v. United States, it was said that in interpreting fairness and equity in public utility holding company simplification cases, "priority is satisfied by giving each class the full economic equivalent of what they presently hold" (118, p. 199). Liquidation value was held to be only one factor to be considered, rather than the determining factor.

In the investment value approach under the P.U.H.C. Act, the investment features of the old securities are measured against the future earnings available for all securities to determine whether the most junior securities may participate. Earnings attributable to preferred stock are determined as a range and the relative distribution to the preferred and common stock is established by the capability of dividend accumulations on the old preferred stock being repaid through earnings over a finite number of years, in addition to the payment of the regular dividends. Junior classes are permitted to share in reorganization plans only if there is a reasonable chance of earnings being available for them in the foreseeable future. Only securities for which there is no hope are eliminated, and this rule applies even if such securities possess a present market value.

The investment value approach as applied to the junior securities in P.U.H.C. Act cases by-passes the finding of an enterprise value by the capitalization of earnings method. The approach emphasizes expected earnings as the source of value for these securities. The method

involves segmenting layers of remaining earnings available to junior classes to establish the proportions of new junior securities to be distributed between the old junior classes. The determination of future earnings is made in much the same manner as in Chapter X cases, except earnings are determined as a range, with a maximum and minimum within which the actual earnings are expected to fall. The objective appears to be to find value for the old common stock whenever possible. If the minimum earnings forecast were to be insufficient for such a finding, no participation would be allowed to the common stock. Since a total valuation is not required, no rate of capitalization or discount is used up to this point. However, if some earnings should exist for common stock, different capitalization or discount rates are assumed for each layer of earnings in order to determine the allocation of new securities between the two junior classes. In the event a substantial equity remains for the common stock, more attention is given to the liquidation rights of the preferred stock than if little equity remains for common stock. Consideration may be given to improvements in earnings coverages applicable to junior securities which result from improvements in capital structure. Such improvement in capital structure would be one which reduced prior charges by reduction in interest rate or by compensation of a portion of the debt in cash. The obvious purpose of the legitimate investment standard is to observe absolute priorities of creditors, investment values of preferred stock claims and to find an equity for the old common stock whenever possible.

Investment value under Section 77

There is some evidence that the same philosophy governs many aspects of railroad reorganizations under Section 77 as that which

governs P.U.H.C. Act reorganizations. According to Blum, the I.C.C., also, apparently takes "investment features into account" when determining "full compensation without using dollar values" (98, p. 424, n. 16). The tendency of the I.C.C. to heed the probable investment value of the new securities in relation to the old securities is apparently to be found in its use of the equitable equivalence of the "rights surrendered" of the Milwaukee case as a guide to reorganization value (98, p. 427, n. 25). Blum concluded that the problem would not be serious with respect to senior securities, but that while the "investment quality of old inferior securities" may be taken into account, "the investment value doctrine" is not consciously being used (98, p. 424).

In establishing the rights of junior securities, inter sese, there is a tendency to compare directly the investment features of each class of old securities with the investment features of the new securities for which they are to be exchanged. Blum concluded that it should be clear that this is not the same as the investment value approach of the P.U.H.C. cases. However, De Forest Billyou was of the opinion that the investment value doctrine has been applied in bankruptcy reorganization (41). Blum, also, has admitted that the "investment value standard of measuring claims" has not been rejected for all purposes in bankruptcy reorganization (98, p. 429).

Implications for Chapter X reorganizations

The investment value approach as outlined above for the P.U.H.C. Act reorganizations tends to recognize and compensate creditors' claims in terms of the entire contract, but recognizes junior claimants mainly

in terms of claims on residual earnings. It is possible that in certain cases, the investment value approach would provide larger total valuations than those provided by the S.E.C. under Chapter X.

The reason for the possibility of the investment value "valuation" being substantially different is that under Chapter X capitalized value is determined as the earnings from assets instead of the earnings attributable to certain securities. Consequently, if an overall rate of capitalization of earnings from assets produces a certain valuation, this becomes the total asset value and the maximum value available for all securities under Chapter X. The recognition of earnings available to each layer of security in order of priority under the investment value approach may permit a finding of a higher valuation, since application of the method depends on earnings coverage for each layer of security in order, and, consequently the total nominal amount of securities may be greater. Also, the value of new securities at the lower levels will be established primarily by their new claims on earnings rather than their new liquidation rights. This is substantially the position taken by Harry G. Guthmann who has said that emphasis on "allocation of earnings rather than a capital sum has the advantage of reducing the importance of a more conjectural 'valuation of the business' with its need for a debatable 'rate of capitalization'" (63, p. 751).

Under Chapter X, both liquidation and investment rights may be recognized, even at the level of the junior securities. This tendency places an extra demand on the capitalization of earnings valuation, which is believed to be conservative in order to meet the full compensation requirements of the absolute priority rule. The tendency to

observe both liquidation and investment rights was noticed in a number of Chapter X cases. In achieving full compensation for the first preferred stock in The Higbee Company case, the Commission approved a plan in which the old preferred's claim on dividend income was substantially the same as prior to the reorganization (69, pp. 7-8). The old dividend was 7 per cent and the new dividend was 5 per cent, but the quantity of new preferred was increased by about one-third, making the claim on income about one-third more, or 6.52 per cent. The reduction in dividend rate would seem to deprive first preferred shareholders of part of their claim on income. The old preferred stock should have received $7.00 on every $100 share, but the new shares represented about one-third more in principal amount, so that it would cost the company $6.52 in dividends for each $100 of old claims. It could be argued that it was really the old preferred shareholders' capital which the debtor had retained which necessitated the larger payment, but it should also be clear that the shareholder had new liquidation rights one-third larger, in addition to a tentative claim on both assets and earnings in the form of 17 per cent of the new common stock. It is obvious that this is an example of complete preservation of the claim on both assets and earnings.

It is probable that the full operation of the investment value approach under Chapter X would result in considerable difference in the distribution of value as compared with the present procedure. This would be especially likely where the old preferred stock was the senior security. If the contract had been favorable as to the rate of dividend, the old preferred would fare well in the reorganization, but not quite as well as under its liquidation rights. On the other hand,

non-cumulative preferred stock with large arrearages would have a low present investment value, but a liquidation value of par or better. The amount of valuation needed to compensate the stock under the liquidation standard would be very high, when established by an overall rate of capitalization of earnings. On an investment value basis such a preferred stock may be actually inferior to common stock, Only the action of creditors would be likely to cause its liquidation rights to mature, since the corporation would not be expected to redeem such securities.

Legal precedent for Chapter X

The investment value doctrine under the Public Utility Holding Company Act is governed by the same general standards of fairness and equity as Chapter X. Such general standards govern priorities in reorganization under conditions of solvency and insolvency. In the simplification cases, the corporation is reorganized as if it were solvent. Under Chapter X, corporations are reorganized as going concerns, however, they are treated as if insolvent. The precedent for these distinctions seems to be well established, but has been subjected to some questioning. De Forest Billyou has argued that if properly read the precedent cases reveal an applicability of the investment value doctrine of the P.U.H.C. Act to bankruptcy reorganization (41) (42). Billyou's conclusion turns mainly on the fact that there is too much tendency to regard the Los Angeles Lumber case and the Consolidated Rock Products case as final, and that later cases, including the important railroad cases, support something other than recognition of liquidation rights, alone, as ruling in bankruptcy reorganization (42, pp. 1380-1383). The question cannot be settled in this dissertation, but there is little

doubt of the tendency of the S.E.C. to take investment features into account under Chapter X when compensating old claims with new claims.

Summary.- It is probable that there is no legal basis for the use of the "legitimate investment value" doctrine of the United Light decision in Chapter X reorganizations. Nor is the S.E.C. likely to apply the principal methods it has developed for awarding value in P.U.H.C. cases to its Chapter X cases. It will probably continue to examine investment features of junior securities to establish the rights that are to be compensated and the manner in which they are to be compensated. In achieving full compensation, at least full liquidation value will be awarded from the value of the going concern as established by the capitalization of earnings method. This valuation may be substantially different from one established by the legitimate investment value doctrine.

The Segmental Earnings Method

There is a distinct possibility that valuation produced by capitalizing earnings necessary for bond interest at one rate and earnings available for equity securities at another rate, rather than capitalizing all earnings at a single rate, may yield different valuations. This possibility is based on two considerations. First, an overall rate of capitalization is a blunt tool likely to produce an inexact result, as pointed out in Chapter III. Second, the risk related to the attainment of a large quantity of future earnings may be different from an average of the risks related to the attainment of different segments of the same quantity of future earnings.

In nonreorganization cases, an alternative to the determination

of present value by the use of a single rate of discount is to apply different rates of discount to different increments of income, on a premise that these increments bear different risks as to the probability that they will be realized. The value in this approach will be highly dependent on the several rates of discount chosen. This approach is often applied to the income increments which accrue at different times in the future. The value in the latter approach will vary much more than with the use of the same set of rates for each year's income.

Variations in results from selection of different rates

Large variations may be obtained in resultant rates of capitalization applicable to junior securities, depending on the overall rates of capitalization used to produce a certain valuation, and depending on the quantity of senior securities and the rates at which the earnings required to pay their charges are capitalized. This principle may be demonstrated by the Keeshin Freight Lines case (85). The plan, which was narrowly approved as to its feasibility, provided for debt of $1,295,000, preferred stock of $620,000, and common stock and surplus of $447,000 for a total of $2,362,000 (85, p. 23). Earnings of $500,000 before taxes and $310,000 after taxes were capitalized at 15 per cent on the after-tax basis to produce a valuation of approximately $2,100,000 for the earning assets (85, p. 15). Additional elements of value produced the valuation of $2,362,000 represented by the capital structure.

Approximately 75 per cent of the debt was to be in the form of notes at an interest rate of 3 per cent. An additional 6 per cent of the debt was to be in the form of assumed mortgages at an interest rate

of 6 per cent, and the balance of the debt (19 per cent) was to be in the form of equipment obligations with no interest rate shown. It was planned that debt reduction would commence immediately, so that at the end of the fourth year debt would be about 35 per cent of the capital structure. However, the following analysis is made based on the beginning capital structure.

Assuming an overall interest rate of 4 per cent for the debt, the segment of before-tax earnings necessary to pay the interest is capitalized at 4 per cent to reproduce the quantity of the debt. After interest of $51,800 is deducted, the before-tax income will be $448,000. After an additional deduction for corporate income tax at 38 per cent, $277,900 of earnings after taxes remain to be capitalized. Since the debt of $1,295,000 consumed 55 per cent of the total value, $1,067,000 remained for senior and junior equity. After-tax earnings would have required a rate of capitalization of 26 per cent to equal the 15 per cent overall rate of capitalization. A rate of capitalization of 26 per cent applicable to equity is a fairly high rate, but when $620,000 of that equity is noncumulative preferred stock at an average dividend of 3-1/2 per cent, the rate of capitalization attributable to the common stock equity alone becomes 58 per cent, if applied to after-tax earnings. There is a strong possibility that the rate of capitalization of 15 per cent selected by the S.E.C. was too high for the facts of this case. While 1947 was a year of low price to earnings ratios, the longer term relationships should govern these situations.

Justification for use of separate rates in reorganization

Justification for the use of separate rates of capitalization

in reorganization has been made by Henry B. Gardner, among others (119, pp. 460-461). Gardner has explained that if a bondholder is asked to give up his bond for a common stock, his risk related to receipt of income has increased, therefore, he could be compensated by a claim on a larger quantity of earnings. However, this increase in earnings should not be disproportionate to the increased risk. It appears by this analysis, also, that the form of the capital structure would have considerable bearing on the rates of capitalization of the two segments of earnings and of the overall earnings.

Professor Kenneth Field has taken an approach which uses economic analysis to select rates of capitalization applicable to two segments of earnings, those for debt and those for equity (120, pp. 21-24). Field suggests that, under the principle of opportunity costs, the rate applicable to the first segment of income on old investments should be the current market rate of interest for new investments (120, p. 22). Any higher rate applied to this segment should be based on the higher risk related to the return of the invested or committed capital.

Field contended that the S.E.C. was incorrect in selecting an 8 per cent rate of discount for the earnings of the San Francisco Bay Toll-Bridge Company for an expected 37-year period. He said that a high rate applied to a capital structure which consisted of a large proportion of bonds was not justifiable. The risk attached to the bonds being repaid should not be more than twice the rate of interest on the bonds, particularly since the principal amount of bonds was to be reduced. In this analysis, Field concluded that, based on the 5 per cent risk differential, the bonds could be retired in fifteen years, instead of the thirty-seven years over which the capital was to be

returned, according to the plan (120, p. 23).

Additional problems in reorganization

In the San Francisco Bay Toll-Bridge case, at least one additional problem was involved. Through the use of the 8 per cent rate of capitalization recommended by the S.E.C., the valuation was $2,590,000 (61, p. 3). Under this valuation, the corporation was insolvent, since the first mortgage bonds aggregated $4,303,000, exclusive of accrued interest. The plan which was subsequently approved by the court provided for bonds in this amount, plus 8,606 shares of $1.00 par value common stock (120, p. 23). The bonds in the proposed plan were to carry a rate of interest of 3 per cent and earnings available for these charges were estimated at $220,000 annually. The S.E.C. said that the interest rate was not realistic, therefore, it would not approve the issue (61, p. 4).

In cases in which corporations are determined to be insolvent, the assets belong entirely to the mortgage holders, except those allocated by stipulation of the court and the free assets. It appears that, in the San Francisco Bay Toll-Bridge case, the first mortgage bondholders desired the largest possible nominal quantity of bonds in the capital structure and were willing to forego a higher rate of interest to secure that quantity. In this case, it is difficult to know what the appropriate rate of interest for the debt portion should be, or what the appropriate quantity of debt should be. It may not be determined from the advisory report whether the bondholders as a group were interested in maximizing the future liquidation value of their securities or in maximizing the market value of their securities. It appears

that they were attempting to maximize the present value of their securities through receiving the largest possible nominal quantity of liquidating value. In reorganization, the reasoning of security holders is probably different from a situation in which bonds would be purchased in the markets for both new and outstanding bonds, and in which all factors bearing on value would be considered.

It is suggested that the two-way segmentation of earnings method advocated by Field poses two related problems with respect to the debt. These are: (a) the proper rate of discount to be applied to the debt segment of earnings, (b) the total amount of earnings or the percentage of a given quantity of earnings which should be allocated to the debt securities. It appears that these problems may be solved only under two kinds of assumptions. The first kind of assumption is that old claims should be continued, e.g., the old senior debt should be continued in approximately its same amount and at the same rate of interest. This would fix the total earnings and the rate of capitalization applicable to the debt securities. The second kind of assumption concerns an arbitrary division of the earnings, such as 25 per cent or 50 per cent for interest on debt. However, the amount of debt securities that these earnings could support could be determined only by reference to the market for these securities.

The problem with respect to the equity portion appears to be not so serious as those related to the debt portion. The rate of capitalization on equity is dependent on the amount of earnings allocated to the debt for a selected valuation, and may become the test of the appropriateness of the valuation, if a standard for rates of capitalization applicable to equity is available.

A different, but equivalent, approach is to apply a standard rate of capitalization to the earnings available for the equity securities to establish the proper valuation. It is in the lack of knowledge of the appropriate rate of capitalization for equity that a problem may arise. This problem will be treated in the final section of this chapter.

Market value and the cost of capital

Both Gardner and Field appear to have taken the traditional position that the use of various amounts of debt in the capital structure will produce different total values of securities. This is based on the traditional view that debt funds are cheaper than equity funds. If a substantial amount of debt is used in the capital structure, a lower rate of capitalization may be applied by the market to the interest payments than to the rest of the earnings, thereby providing a larger value for the levered capital structure than for the nonlevered capital structure.

Harry G. Guthmann is of the opinion that the "generous use of prior securities" has the advantage of maximizing the total market value of securities in reorganization (63, p. 749). However, the means whereby satisfactory compensation would be achieved is circumscribed by certain modifications which lean toward maintenance of relative priority of income positions, rather than by strict observation of liquidating claims on asset value. A substantial part of the present chapter deals with the question of whether these, and similar modifications, would achieve the maximization of value to all security holders at the time of reorganization and after reorganization, and whether such modifications are within the permissible limits of fairness and feasibility.

It should be noted that liquidating values are generally concluded to provide greater value to senior interests as opposed to providing total value for all interests. The effect of valuation of reorganization securities by the market has received little treatment. This is because the S.E.C. does not award securities on the basis of present market values, except when such values will assure the payment of the full amounts of creditors' claims at the time of reorganization. However, it should be apparent that market values are in the background of both the awards of securities the S.E.C. is willing to approve and those the claimants are willing to accept.

Financial structure and the cost of capital

The effect of financial structure on the cost of capital has been questioned by Modigliani and Miller (121, pp. 261-297). The writers set up a theoretical model, assuming perfect competition and a nontax economy, to demonstrate that the "average cost of capital to any firm is completely independent of its capital structure and is equal to the capitalization rate of a pure equity stream of its class" (121, p. 268). In that article, the writers concluded that the only difference in cost of capital is due to the corporate income tax effect, and that this is minor (121, pp. 296-297). In a correction, in 1963, Modigliani and Miller admit to larger tax advantages from debt financing than stated in their previous article (122, pp. 433-443).

The question of whether the average cost of capital is completely independent of the capital structure, except for tax advantage, remains a controversial question. However, empirical studies have been made by J. Fred Weston (123, pp. 105-112), and by Alexander Barges (124)

which tend to refute the Modigliani-Miller propositions.

Numerous authorities are in agreement that in the real world of income taxes the total market value of securities of a levered corporation is likely to be higher than those of a nonlevered corporation in the same risk class and having the same earnings before interest. Graham, Dodd, and Cottle point out that "a good part of <u>any</u> suggested gain in enterprise value through creating or increasing the debt component will be accounted for (under existing legislation) by the factor of tax savings — a benefit apparently conceded by those who deny the other claimed benefits" (84, p. 542).

<u>The S.E.C. position on segmenting earnings</u>

The S.E.C. has taken a position on the segmenting of earnings without specific reference to possible corporate income tax savings, in the case of the Aireon Manufacturing Corporation (89, p. 10). The additional trustee had computed the annual before-tax earnings by deducting the interest charge of $34,320 as an expense. The Commission pointed out that "if interest charges on the proposed securities were deducted before determining the earnings to be capitalized, the value of the enterprise would vary in every case depending upon the amount of interest bearing securities and the rate of interest thereon provided for in the plan" (89, p. 10). The Commission went on to state that "in computing the amount of the probable Federal income taxes, approximate deductions for interest on proposed indebtedness should be made where earnings after taxes are capitalized" (89, p. 10). The interest is then added back to the net earnings before taxes to find the total before-tax earnings related to a certain level of after-tax earnings.

In Chapter III, this writer pointed out that such a procedure was not possible unless there was a preconceived notion of the amount of debt that would emerge, and consequently, of both the total valuation and the overall rate of capitalization necessary to produce that valuation. The Commission, itself, in this case pinpointed the fact that the value of the enterprise could vary with the amount of interest bearing securities. However, the Commission has seldom utilized the possible savings in a way to maximize the going concern value to all the interests.

It is also possible to capitalize at the actual interest rate the portion of before-tax earnings required for interest and to use another, presumably higher, rate to capitalize the remaining before-tax earnings, but the S.E.C. has not permitted this procedure either. However, as pointed out in Chapter III, the S.E.C. occasionally applied separate rates of discount to the cash proceeds expected from different types of assets.

Corporate Income Tax Effects

The purpose of this section is to examine the difference in the impact of the corporate income tax on earnings paid out in interest and on earnings in excess of this amount, and, hence on possible difference in valuation between various capital structures. Inquiry is also made into the S.E.C.'s position on possible tax savings.

The theoretical basis

It may be demonstrated that, in a choice between a debt-free and a partly debt capital structure, with a given quantity of earnings, the rate of capitalization required to produce a given valuation is different, due to the tax effect. Assuming a $200,000 before-tax income, a

50 per cent tax rate, and a $1,000,000 capitalized value, the rate of capitalization is 10 per cent after taxes for the debt-free corporation. Assuming the same income and tax rate, $500,000 in 5 per cent bonds would require $25,000 for interest, after which $87,500 would be paid in taxes and $87,500 after-tax income would remain for this portion. Total after-tax income of $112,500 then requires a rate of capitalization of only 8.89 per cent to produce the same valuation. As a result of the same line of reasoning, the application of the 10 per cent rate of capitalization as used for the debt-free corporation would produce a valuation of $1,125,000. This advantage would accrue to senior security holders, as well as junior security holders, due to the tax savings to the company. If we assume a situation in which only one class of old senior security holder is the only survivor and in which all members receive a mixture of several different kinds of securities to include debt, this class as a group is better off than if they had received only common stock, because of the tax savings alone. Using the data in this example, if the tax rate had been 25 per cent instead of 50 per cent, the corporate taxes would have been $43,750 and after-tax income would have been $156,250. Application of the same 10 per cent rate of capitalization would produce a valuation of $1,562,500, or almost 40 per cent higher.

Approved and disapproved requests for debt

There were only a few cases in which the income tax savings were specifically mentioned in relation to attempts to have some quantity of debt approved. In each of these cases the proposed debt was in the form of income bonds. In all cases except one, the debt was

disapproved by the S.E.C. In the Ulen & Company case, the trustee had found a value of $1,279,000 and the S.E.C. was in substantial agreement with this. However, the S.E.C. believed that immediate future earnings of $30,000 instead of $48,000 would be the maximum expected amount (71, p. 19). It was believed that the annual interest charges on $800,000 of proposed 6 per cent cumulative income debentures would not be earned during normal years. The senior interests were apparently willing to accept this issue of debt, plus the 4,000 shares of common stock proposed by the trustee for the Ulen Realization Corporation (71, p. 6). In support of the issue it was said the company would be able "to avoid income taxes by having interest charges equal to or in excess of net income otherwise taxable" (71, p. 20). The Commission stated that such a tax consideration would not be a valid reason for approving the debt issue.

In the Philadelphia and Reading case, the pressure for more debt, for its tax savings, came from the New York Independent Bondholders Committee (62, p. 50). The S.E.C. recognized the possibility of the income tax savings in this case, but said that apparent tax savings of about $20,000 per annum for each $1,000,000 of bonded debt "might be offset by increased excess profits taxes resulting from the reduction in the invested capital base" (62, p. 50). The S.E.C. said it was useless to speculate on further tax aspects because of the uncertainty of the company's future income and of the future Federal tax statutes. The proposed bond indebtedness was $10,600,000. The bonds were to bear 6 per cent cumulative interest, payable only if earned, except that cumulations would be payable unconditionally upon their maturity in twenty years. Interest would be $630,000 per year

and sinking fund payments were contingent on the larger of three measures of the results of operation. Estimated net cash gains would average $1,961,944, and would have covered the interest charge alone 3.09 times. However, the S.E.C. pointed out that net cash gains (after capital expenditures) available for both the interest and sinking fund requirements would be covered between 1.42 and 2.8 times over the next four years (62, p. 49).

In the Warner Sugar case, the S.E.C. recognized the possible value of the tax savings on the proposed $1,200,000 of income debentures of the subsidiary (55, p. 18). While approving the plan, the Commission recommended that the bondholders should forego any possible tax advantages in order to assure that the company would not encounter future financial problems. In this case, the income debentures, which would mature in 30 years, carried a 5 per cent interest rate and would have accumulated interest whether it was earned or not. Furthermore, the plan provided for a sinking fund into which two-thirds of the earnings of the subsidiary would go. Minimum interest requirements would have been $60,000 against estimated earnings of $700,000 for the postwar period and $170,000 per year normal earnings (55, p. 12). This would have been an earnings coverage of about 2.83 times during normal years. Sugar production and prices were reasonably stable due to international agreements (55, p. 8). The debenture issue was approved due to the strong sinking fund provisions.

It appears that the S.E.C. will not normally allow the benefit of debt for its tax benefits to outweigh its feasibility requirements. At least three points seem to stand out. First, income coverage for the debt must be at least two or three times the interest. Second, there

should also be additional earnings coverage for the sinking fund, and earnings should exceed the combined interest and sinking fund requirements by a very substantial amount. Third, both future earnings and future tax rates should be relatively sure.

The question of future earnings is the more important of the last two factors. Theoretically, in cases of assumed perpetual future life, the certainty of the earnings estimate is adjusted through the rate of capitalization. In cases of depleting assets, or of limited economic life, the debt would have to be reduced at least as rapidly as the assets are depleted in order to be feasible. Finally, liquidating plans form unique problems as indicated by the San Francisco Bay Toll-Bridge case (61).

The Commission's position on the tax-free nature of debt

The Commission's position on the tax-free nature of debt has been stated in its fifteenth annual report (91, p. 146). The S.E.C. said that over the past five years it had encountered considerable opposition on the part of security holders to the scaling down of debt because of the desire to retain tax deductions. It said that such opposition was based on the use of inflated earnings as justification. The parties either overlooked the fact that earnings were inflated or hoped they would continue long enough to reduce the debt to "manageable proportions" (91, p. 146). Oddly enough, while the S.E.C. is not likely to allow an unusual amount of debt, the second part of its accusations, rapid reduction of debt, has been one of its chief objectives in many reorganizations.

While the S.E.C. recognizes the value of the corporate income

tax savings generated by the debt, it seldom makes it possible to utilize debt in the desired amount. The Commission appears to have attempted to use a legal case as grounds for refusing requests for generous quantities of debt. In the International Railway Company case, the Commission stated that "the contention that Federal income taxes will be reduced if income bonds are issued is not persuasive" (4:29;575). It asserted that such savings would be dependent on the company's taxable income and the continuation of current rates which could not be depended upon. The Commission cited Judge Moinet, in the case of Barlum Realty Company, to the effect that it would not be appropriate to speculate as to the extent of the tax liability over the future life of the reorganized corporation (108).

Prediction of future tax rates

In theory, it would be necessary to estimate the probable future tax rates in order to determine the amounts of the tax savings. It was pointed out at the beginning of this section that the valuation of the corporation would vary with the tax rates applicable to future earnings, if the same overall rate of capitalization is applied to after-tax earnings. Only by predicting tax rates a reasonable distance into the future may a case be made for the probable tax savings resulting from a postulated future income, unless one were to take the position that only the present level of income and taxes are relevant to a determination of going concern value. However, the Commission's earlier attitude regarding the inability to speculate on future tax rates is untenable.

In recent years the S.E.C. has been forced to take into account probable future Federal income tax rates in determining the after-tax income for several reasons. As pointed out in Chapter III, it is

necessary that after-tax earnings be estimated in every case in which net cash proceeds are discounted down to present value. Also, in many cases, the Federal income tax loss carry over is an important element of valuation. In order to determine the present value of the carry over, the future tax credit must be applied to the future earnings against which the tax loss carry over will be used. For example, in the case of Muntz TV, Inc., the S.E.C. estimated future earnings of $840,000 per year (70, p. 13). The Federal income tax loss carry over was $4,485,000, but was believed to be usable for only four years against the income estimate of $840,000 per year. These tax savings of $420,000 a year for four years, or $1,680,000, would be discounted at the same 12 per cent rate applied to operating assets to add approximately $1,275,000 to the valuation.

The impact of the imposition of a tax has a varied effect on valuation, depending on a number of factors. At least, in the short run, there is a tendency for similarly situated industries to be similarly affected. One such similarity would be the amounts of financial leverage employed by different companies. Changes in corporate income tax are currently infrequent and small in amount.

Conclusions

The S.E.C. recognizes the value of the corporate income tax savings, but is not likely to allow its utilization to the extent desired by security holders. Some of this pressure comes from senior security holders who are willing for the corporation to issue larger quantities of debt than allowed. The appropriate quantity of debt may not be determined without further examination of feasibility requirements, but it appears to be in excess of the amounts allowed by the

Commission.

In recent years, the S.E.C. quite properly estimates the future tax rates in certain types of cases, even though tax rates may change in the future. The same procedure should be applied in all cases. Possible changes in tax rates after reorganization should have no different effect than possible changes in earnings after reorganization. Both types of changes may be taken into account at the time of reorganization to determine the maximum going concern value. Only by the authorization of the largest feasible quantity of debt and other prior securities may the corporation be able to maximize its value at the time of reorganization.

Feasibility Requirements for Debt and Other Prior Securities

The purpose of this section is to obtain a clearer understanding of the factors which may limit the quantity of debt and other prior securities in the capital structures of reorganized corporations. This determination will be made on the basis of the S.E.C.'s standards of feasibility, and the consistency with which they are applied.

The Securities and Exchange Commission's standards of feasibility

The general requirements.- The Commission's standards of feasibility are not as well established as are those for fairness and equity. Not only do the legal cases have little to say on the specific requirements for a feasible plan, but the Commission, itself, usually states its standards only in general terms. The general requirements were treated in Chapter IV. These include requirements that the corporation emerge from reorganization with a sound capital structure, assurance of

adequate working capital and nondeceptive securities. Sufficient cash and earning power to meet all financial obligations, including capital expenditures, and interest and principal on debt when due, are said to be essential. Dividends on preferred stock are somewhat of the same character as interest and principal on debt in Chapter X reorganization and, therefore, ability to meet dividend requirements in the not too distant future must be preserved in the plan in order for it to be feasible. Common stock should be fully covered by asset value established by the capitalization of expected earnings. Some major subsidiary feasibility requirements may have an important bearing on the capital structure which will be accepted and, therefore, should be mentioned.

Future financing.- Provision for future financing may be considered by the Commission in its feasibility requirements. Provision for borrowing capacity to meet future financial needs may be made in the capital structure. Or, provision may be made in the plan itself for bank borrowing over a period of two or three years, as was done in the McKesson & Robbins case (58, p. 27).

Restrictions on management.- Restrictions on management, as to sale and purchase of assets and flotation and retirement of securities, will have to be recommended at the time of the advisory report. In the Childs Company case, feasibility was predicated on the sale of unprofitable property by the management as the opportunity arose (125, pp. 2-3). The latter failed to do this, despite a highly favorable market, and the S.E.C. could only suggest that the program be carried on more vigorously. However, a number of restraints have been suggested and incorporated into various securities contracts.

Debt reduction.- Provision for debt reduction is allowed in plans of reorganization under Chapter X. Section 216(9) provides that the plan

> . . . may include, where any indebtedness is created or extended under the plan for a period of more than five years, provisions for the retirement of such indebtedness by stated or determinable payments out of a sinking fund or otherwise, (a) if secured, within the expected useful life of the security therefor, or (b) if unsecured or if the expected useful life of the security is not fairly ascertainable, then within a specified reasonable time, not to exceed forty years (1:52;896).

The Commission has usually taken the position that early retirement of debt works to the benefit of the common stockholders, even though heavy early payments may cause the postponement or the limiting of dividends (50, pp. 84-85). According to Max Radin, as far as the courts are concerned, "the fairest among several feasible methods is one that gives the creditors the largest amount of disposable assets, and offers the greatest likelihood that the creditors will soonest be paid out of prospective assets" (126, p. 476).

Standards for capital structure

Specific standards are seldom used by the S.E.C. in testing the feasibility of the new capital structure. The securities markets have set certain specific conventions for earnings and asset coverage for bonds and preferred stock. Graham, Dodd, and Cottle have reported their ideas on these conventions (84, chaps. 23-29). However, these standards are intended for high grade investment securities. These writers have something to say on reorganization securities. In speaking of the desirability of having a large amount of debt, particularly income bonds, in capital structures of reorganized companies, they stated that the advantages "could well be so large as to outweigh the desirability

of a thoroughly sound capital structure" (84, p. 662, n. 7).

Chapter X corporations may be considered to be much like new closely held corporations, as treated by Dan T. Smith (127, pp. 143-255). However, probably soon after reorganization, the corporation may begin to take on some of the characteristics of a widely held corporation. If its shares begin to be publicly traded, it may then lose the character explained by Smith. However, at the time of reorganization there may be a distinct advantage to the equity recipients, and to all security holders, to start with a "maximum of senior securities, preferably debt obligations" (127, p. 155). With respect to asset coverage, but not to earnings coverage, there may be another very good reason why reorganization securities need not be held to the same percentages required for prudent investors. Theoretically, in reorganization, the valuation of the assets is discounted down to an approximation of their true worth, either as to going concern value or as to liquidation value. In going concerns there is a distinct probability that assets which are security for the debt are valued on the books at more than their bankruptcy liquidating or true reorganization value. In a reorganization, due to the new valuation, no need exists for a margin for this possibility and new prior securities could be authorized close to full valuation in some cases. Such an asset coverage requirement would mean that available earnings may place the only limitation on the quantity of debt and preferred stock.

Capital structures
approved by the S.E.C.

In approving certain capital structures, the S.E.C. seldom explains the standards it uses. However, lack of asset coverage may be

mentioned in a disapproved case. The S.E.C. has presented earnings coverages in both kinds of situations, but does not say that it is comparing these with any known standard. Therefore, the standards must be derived largely from the cases approved.

Asset coverage.- Asset coverage appears to vary considerably with the type of assets and the circumstances of the reorganization. The S.E.C. will approve ratios as high as 70 per cent for real estate companies (103, pp. 7-12). It has indicated that "under certain circumstances a capital structure which would not be feasible for a going concern may be permitted in the case of an enterprise which has liquidation as its sole purpose" (62, p. 48). Such capital structure would require that the company diligently pursue sale of its assets, that it has a reasonable chance of liquidating the debt, and that the retention of the debt in the same form be important for the purpose of preserving the priorities of the senior indebtedness.

The Commission was willing to accept a debt ratio of 79.2 per cent for the Green River Steel Corporation (73, p. 18). As pointed out earlier, the highest debt ratios in plans approved for internal going concern reorganization of industrial corporations by the S.E.C. were 47 per cent in the Minnesota and Ontario Paper case (50, pp. 1, 81-82), and 30 per cent in The Higbee Company case (69, p. 6). However, in the Warner Sugar Corporation case, a capital structure with a higher debt ratio was approved as to feasibility, although the plan was found to be unfair (55, p. 1). The new income debentures were to be 70 per cent of the valuation, while the remainder of the capital structure consisted of equal quantities of Class A common, and common stock (55, p. 16).

Earnings coverage.- Earnings coverage, like asset coverage,

appears to vary with the circumstances. The tendency of the S.E.C. to use a somewhat more liberal standard for plans of reorganization contemplating the merger of the bankrupt corporation with a solvent operating company is demonstrated by the Northeastern Steel case (74, p. 22). The S.E.C. found the capitalization quite feasible, even though Northeastern would be unable to pay interest from its own earnings until the third year. Carpenter Steel, the new parent corporation, was free of debt. The $6,000,000 in new first mortgage bonds of Northeastern would be one-half of its own valuation, but about one-eighth of the new book value of the combined companies.

In the Minnesota and Ontario case, it was calculated that the interest requirements would "be covered 3.1 times on the basis of the estimated earnings" (50, p. 82). In cases where the senior debt was either short-term or intermediate-term, the earnings coverage was somewhat higher in most cases. In The Higbee Company case, interest would be covered about eighteen times before taxes (69, pp. 6-7, 19). In the McKesson & Robbins case, earnings of $4,000,000, before taxes, of the drug departments alone would cover the yearly interest of $472,000 eight times (58, pp. 14, 26).

In the Sayre & Fisher Brick Company case, the plan provided for no debt, although the corporation was insolvent and bondholders' claims were several times as much as the valuation (59, pp. 4-5). A total of $268,430 par value 5 per cent cumulative preferred stock, representing 24 per cent of the capital structure, was proposed. Even though preferred dividend requirements would be only $13,000, the large fluctuations in earnings of businesses of this type, caused the Commission to recommend an all common stock capitalization (59, p. 11). The S.E.C.

pointed up the importance of keeping fixed charges at a minimum, due to wide fluctuations in the debtor's past operating results (59, p. 6). Expected earnings were $100,000, on which no capital improvement demands would be placed. After taxes, the dividends would have been covered approximately five times on this cumulative preferred stock, and the S.E.C. admitted that the earnings coverage would be "adequate" (59, p. 11). It appears that the use of income bonds in the approximate quantity of the proposed preferred stock would have provided earnings coverage at least 50 per cent higher and would have been sufficient to pay the interest and retire the bonds within a reasonable period.

Combined coverage.- The combined coverage for interest and sinking fund places an additional limit on debt in reorganization. It appears that the limitation is a serious one in some cases with respect to the rather rapid retirement provisions for short term debt, and at times, even in relation to intermediate-term debt. However, there were a number of cases in which, despite rather rapid retirement of debt, the combined coverage seemed ample.

The trustee's first plan of reorganization, as amended, in the Childs Company case proposed debt which was said to be "moderate" in relation to the valuation (54, p. 8). Annual before-tax earnings of $1,100,000 and after-tax earnings of $700,000 would very well cover the partially contingent interest of $60,000 and amortization of $30,000 on the estimated $1,700,000 in mortgages to be assumed, plus the $60,000 of interest and fixed amortization of $200,000 on a proposed $2,000,000 bank loan. The proposed debt was also said to be moderate in terms of asset value of $10,300,000. Interest would have been covered nine times before taxes and amortization of debt would have been covered 2.6 times

after taxes. However, since the working capital appeared to be adequate, it was recommended that the bank loan be deferred (125, p. 5). The capital structure, as approved, contained no debt except for $1,600,000 in assumed mortgages.

The S.E.C. usually recommends that at least 50 per cent of the earnings after taxes and interest be applied according to formula to debt retirement. In the Philadelphia and Reading Coal and Iron case, the retirement was tied to the depletion of the assets on a tonnage basis (62, p. 48). Very rapid reduction of short term debt was proposed and approved in many plans of reorganization. Many of these plans called for omission or deferment of preferred and, especially, common stock dividends until the debt was substantially or completely extinguished, e.g., The Higbee Company (69, p. 7).

The foregoing may suggest that the combined coverage need not apply to both debt and preferred stock. However, this is only the case when the debt is retired over a very short period. In cases of the existence of intermediate-term and long-term debt in the capital structure ahead of preferred stock, earnings coverage for preferred stock should include interest and sinking fund requirements for debt. In the Keeshin Freight Lines case, it was estimated that the first preferred dividend requirements and all prior charges would be covered 3-1/2 to 4 times (85, p. 22). It was said that the second preferred stock would receive no dividends until after the fifth year at which time both classes of preferred stock would be covered 3-1/2 to 6 times.

Capital improvements.- Provisions for capital outlays or for funds for improvements will require additional earnings coverage. Such provisions are not a normal part of plans of reorganization, although

they may be required by the condition of the property. Such expenditures must not impair present and future working capital or endanger the payments of interest and principal. Consequently, provision in the plan for capital expenditures necessary to produce a given volume of earnings must be paid from those earnings, unless provided for in the form of present or future financing.

A solution to the combined earnings coverage requirement

A possible solution to the problem of the combined coverage for interest, sinking fund, and capital outlays is presented by certain provisions of the Trustees' amended plan of December 4, 1939, and in the Bondholders' Protective Committee's plan proposed in the Minnesota and Ontario Paper Company case (50, pp. 81-86). The debt of $12,200,000 represented 47 per cent of the valuation. Annual interest charges of $610,000 (5 per cent rate) were to be paid only if earned. Provision was made for a sinking fund of 50 per cent of the annual net earnings "to be used first for the discharge of unpaid interest accrued to the next preceding January 1st for which no net earnings are available" (50, p. 84). The balance in excess of the interest was to be used for retirement of any outstanding bonds. Net earnings here were defined as before depreciation and capital gains and losses, but after deduction of $400,000 as a reserve for betterments, accrued unpaid interest, and deficiencies in the sinking fund due to interest payments.

From the estimated before-tax earnings of $1,900,000, the deductions would be fairly large, representing as much as two-thirds of the net operating profit. However, since the deductions were for capital improvements, also, they would probably not be deleterious to the

welfare of the only remaining interest, the common stock, representing 53 per cent of the capital structure. The directors could defer the sinking fund payments if making them would leave insufficient working capital. Assuming an upward trend in earnings, the percentage going into the sinking fund would drop and the percentage to the common stock would increase.

The plan, which the S.E.C. approved after suggesting some amendments, allowed for a relatively large quantity of debt and still provided for adequate present and improved future income for junior securities. However, the plan may have been deficient in not providing additional types of junior securities, such as the preferred stock suggested by the junior creditors (50, p. 82). Interest was covered 3.1 times and a reasonable amount of cumulative preferred stock could have been carried without reducing the value of the common stock.

This apparently liberal and satisfactory solution to the problem of the combined coverage requirements could be used as a test of the adequacy of the capital structure in other plans. Of course, the companies should be comparable in important respects, as in the following example. In the McKesson & Robbins case, the new capitalization was said to be sound as indicated by the coverage of charges on senior securities (58, p. 26). The expected charges were annual interest $472,000, sinking fund payments $472,000, and preferred stock dividends $324,500. The total charges were $1,268,500 against estimated future earnings of $4,000,000 for the new corporation, exclusive of possible earnings which might be contributed by the liquor department. McKesson & Robbins could be viewed as above average quality for reorganized corporations and probably more debt and other prior securities would have

been justified. The coverages would have been as follows for the earnings of the depression years before reorganization:

	1936	1937	1938
Interest coverage:			
Before taxes	7.45	7.94	5.21
After taxes	6.91	7.05	4.82
Interest and sinking fund coverage:			
Before taxes	3.72	3.97	2.61
After taxes	3.45	3.53	2.41
Interest, sinking fund, and preferred dividend coverage:			
After taxes	2.57	2.62	1.79

Conclusions

The need for simplification of capital structure is possibly implicit in the several statements in the precedent cases to the effect that creditors may be awarded inferior securities (3, p. 686). This will be necessary when claims are matched against a reduced valuation of assets; however, the new capital structure could appear much like the old, except as to the amounts of the securities. The need for simplification is legally justifiable and obviously necessary, in some cases. It appears that the S.E.C. may be overzealous in trimming down debt and other prior securities, in most cases.

Limitations on the Variety and Quantity of Securities in Capital Structures

The purpose of this section is to obtain a clearer understanding of some of the additional factors which may limit the variety and quantity of securities in capital structures of reorganized corporations. Compensatory devices are examined as means of finding a more accurate

valuation.

Effect of valuation found

In the previous section, the analysis was based on an assumption of correct earning power valuation for the purpose of determining the appropriate ratios for debt and other prior securities. In the present section, the estimate of earnings is accepted, but the question of total valuation is left open. Many plans of reorganization are not approved because of a reduction in valuation by the S.E.C. which had the effect of making the new valuation deficient with respect to the proposed quantity of securities. While it is technically possible to begin corporate life with a capital surplus, it is not technically possible to issue in reorganization a larger nominal quantity of securities than the specific dollar valuation found.

An attempt to issue securities in excess of valuation will normally be unfavorable to senior interests. In commenting on the trustee's plan in the Flour Mills of America case, the Commission said that since the company's earning power was doubtful, it should not have a substantial quantity of funded debt (60, pp. 17, 27). The proposed convertible term notes in the amount of $2,661,000 represented more than 100 per cent of the valuation of $2,160,000 found by the S.E.C. The so-called term notes could not be defaulted prior to their maturity in twenty years and would be subordinated to all future current liabilities (60, p. 6). The S.E.C. held that they would be deceptive in these respects and so unfavorable by their terms to be worth substantially less than the face amount of the noteholders' claims. While these notes undoubtedly had a number of objectionable features, the main reason for the finding of deficient value was due to the S.E.C.'s

lowered valuation. If the trustee's rate of capitalization of earnings at 8 per cent had been used instead of the S.E.C.'s rate of 12 per cent, the notes would still have represented about 80 per cent of the valuation. However, the Commission's estimate of earnings turned out to be quite low within three years (24, p. 24).

Protective features

New securities may have incorporated into them protective features, such as provisions for sinking funds, and limitations on additional debt, dividends to common stockholders, and executive salaries. Such provisions should increase the value of the award whether incorporated into senior securities or into junior securities. Provisions of this type are especially appropriate for weak securities, such as income bonds or preferred stock. However, they may not be shown to be qualitative compensation if they are normal for securities of the particular type. The extent to which securities may be "improved" at little or no cost to the company is difficult to determine.

The cumulative feature is highly favored by the S.E.C. The Commission utilizes a method whereby restrictions are placed on the payment of dividends on preferred stock until the intermediate or short-term reorganization debt is retired. This is said to be "found only in reorganization plans" (128, p. 774). It is usually conceived that all accumulations will be paid within a year or two. Voting rights, in case of default or until accumulations are paid, are required under Section 216(12)(a) of Chapter X. The S.E.C. has suggested such amendments in several cases, e.g., The Higbee Company (69, p. 26). Restrictions on dividends should tend to depress the market value of stock temporarily.

The Commission seems to be against voting trusts for the common stock, even though voting trustees are allowed under Section 216(11) (1:52;897). In the McKesson & Robbins case, the plan provided that the trustee should "retain the defense of all claims against the debtor or the estate not finally allowed or disallowed prior to confirmation, and that the court shall retain jurisdiction over the Trustee, the company, the property dealt with by the plan and such claims until final decree" (58, p. 27). The Commission stated it believed the defense of claims would be more appropriate if in the hands of the new corporation, rather than in the hands of voting trustees.

Variety of securities

A larger variety of securities in the capital structure may permit a larger nominal quantity of securities to be authorized and issued. The capital structure of some of the railroad reorganizations indicate this possibility. It would be possible to have at least one fixed interest mortgage bond, one or more issues of income bonds, one or more issues of preferred stock, common stock, and even one or more issues of stock purchase warrants. Such complex capital structures are not so likely to be found today, especially in industrial reorganizations. However, the S.E.C. has shown a willingness to approve plans of reorganization with a number of layers of securities, particularly intermediate-term notes, in order to preserve priorities.

Generally, however, the Commission has sought simplification of capital structure. The S.E.C. questioned the feasibility of a capital structure consisting of five different kinds of securities in the Aireon Manufacturing case (89, p. 12). The plan, which included an issue of five-year notes and an issue of ten-year notes, was said to be

unnecessarily complex and not needed to preserve the rights of the parties.

Some financial writers conclude that a generous use of contingent income securities in the capital structure of the reorganized corporation will increase the total value of securities outstanding, hence reducing the cost of capital to the corporation. Harry G. Guthmann gives the example of the investment companies, whose values of securities outstanding normally differ from the values of their assets (63, p. 747, n. 19).

The possibility of increasing the market value of the corporation in reorganization through the use of contingent income securities in the capital structure will probably be found mainly in instances in which the contingent income securities possess a highly tentative claim on future earnings. This is because the contingent income securities have purely speculative values over and above their investment values as claims on present earnings. Insertion of one or more such securities in a normal two or three level capital structure could be expected to provide considerable value for such securities without an equivalent reduction in the value of the securities junior to them.

Income bonds have an advantage in this regard over preferred stock in the tax deductibility of interest on the bonds. From the standpoint of the corporation, income bonds have an advantage over ordinary fixed-interest bonds in that interest need not be paid unless earned. According to Graham, Dodd, and Cottle, "the issuer can look forward to retiring most of the principal through tax savings and probably to interest savings as well" (84, p. 396).

The Commission has shown a willingness to accept income bonds

and preferred stock in many Chapter X cases, but requires that the full amount of the income necessary to service them be entirely capable of being earned. Furthermore, the interest for the income bonds must be predicted to be forthcoming immediately, and in no Chapter X case examined was the new income bond other than the senior security. The fact that such bonds were substituted for first mortgage bonds in many cases would pose a question of fairness to junior security holders, if the step-down in quality permitted a quantitative step-up. In these cases, earnings coverages for the income bonds were entirely adequate, and no loss of status should be involved regarding them. It is posited that when sufficient earnings for both interest charges and for retirement of bonds are available, the senior security should be fixed interest bonds. Following this issue, may be an issue of income bonds or preferred stock, as suggested by the circumstances. In any case, in the creation of claims on future earnings, the proportions of prior securities should be "judiciously combined" (63, p. 748).

Compensatory devices

In the opinion of Guthmann, possible errors in the estimating of future earnings may be offset by "compensatory devices, such as the sinking fund, the conversion privilege, and the stock purchase warrant" (63, p. 751). Such devices may have the advantage of creating additional value in reorganization, as well.

The sinking fund.- The use of the sinking fund for bond retirement has been covered in connection with specific securities issues. Such provision could very well have the effect of strengthening otherwise weak issues, thereby bolstering their value for purposes of compensation when the face value of the bonds are the measure of the

awards. On the other hand, too large a cash drain for this purpose may eliminate the possibility of issuing other prior securities in the new capital structure. In most approved reorganization cases, the provisions for either sinking funds or capital expenditures are sufficiently burdensome to prevent any undue advantage accruing to new junior securities.

Convertible securities.- Convertibles in new capital structures might increase the market value of the capitalization in essentially the same manner as contingent income securities. The convertible feature may have a purely speculative value. This value is dependent on the value of the common stock, if the securities are convertible into common stock, as is normally the case. Theoretically, the value of a convertible security to the corporation is that it permits the payment of a lower rate of interest or dividend than would be possible without the conversion feature. The conversion feature may have an immediate speculative value, and could consequently lower the corporation's cost of capital. Some writers conclude that the convertible feature is a bonus which is added to help sell a bond which is either inferior or which is placed in the market at an unfavorable time.

A convertible quite frequently possesses a value in excess of the market value of the stock into which it is to be converted, as well as in excess of its value as a nonconvertible security. While some dilution might occur in the common stock in case of conversion, the value of the convertible feature as compensation should more than offset the dilution effect. This dilution would be appropriate, if the value should properly belong to the senior security. This situation would occur when award of the convertible privilege increased the value of

the security sufficiently to permit a substantial quantity of common stock to be issued to the junior interest.

The S.E.C. has objected to the award of convertibles to senior interests, if the conversion feature has no present value as a privilege. In the Flour Mills of America case, the S.E.C. objected to the conversion feature in the new senior convertible term notes because it would have "no demonstrable value" (60, p. 25), due to the insolvency of the debtor.

The conversion feature may apply both to bonds and preferred stock. Both types of securities are usually convertible into common stock. Bonds may be convertible to preferred stock. The Commission did not disapprove of this feature in the new second mortgage bonds in the La France Industries case (49, pp. 6, 15-16). However, with respect to "capital income debentures" convertible into common stock in the Griess-Pfleger Tanning case, the S.E.C. said that the conversion feature offered "merely a speculative and highly uncertain prospect for a full return in the future" (52, p. 9). It was said that they were in substance a preferred stock with a conversion feature of little value.

Stock purchase warrants.- Stock purchase warrants have been suggested for reorganization as a means of offsetting the possibility of an undervaluation which unfairly excludes junior interests. Aside from this advantage, the warrants may also provide for a larger market value of securities. The theoretical value of a warrant depends mainly on the exercise price of the warrant and the market price of the common stock on which it is a call. This theoretical value is affected by the duration of the warrant, the number of warrants outstanding, and the speculative interest in the common stock. The warrant tends to have a

greater volatility than the common stock and, in addition, tends to have high market values compared with their theoretical values, which are usually negative. The placing of an exercise price high above the market price at the time of issue postpones actual dilution to present shareholders, but even so, it may depress the price of the common stock to some extent due to the potential dilution which might occur in the future. In reorganization, it may be possible to find greater present value for the corporation by the use of warrants, than otherwise, for the above reasons. Exercise of warrants results in additional cash being paid into the corporation at the time of exercise. From the standpoint of the corporation, this may be a disadvantage, if the corporation does not need cash at the time the warrants are exercised, or if it might secure cash on more favorable terms from other sources. The latter is a logical argument if, as a result of exercise of the warrants, earnings are diluted sufficiently to discourage common stock financing. Also, having warrants outstanding might hamper financing in the period after their issue and prior to their exercise. As a practical matter, many warrants are not exercised even though having value due to the market price of the common stock.

Warrants are of potential real value in reorganization in providing a "call" on value which might become apparent after reorganization, but was not recognized at the time of reorganization. However, the S.E.C. says that valuation only at the time of reorganization is to be distributed. In following this mandate, it says in effect that the variability of common stock values and prices are taken into account in the award to those who receive the junior securities.

Blum, in commenting on the possibility of the issuance of

long-term warrants in Chapter X reorganizations, states that their use is incompatible with the "best estimate" approach to valuation of the S.E.C. (98, pp. 439-440). This is because of the Commission's position that if value is to be found for participation of old security holders, it must be at the time of reorganization. This attitude on the part of the S.E.C. allows no leeway for the possibility of error. The S.E.C. revealed this attitude in early advisory reports, but was willing to approve warrants in one early case. In the Detroit International Bridge case, the issuance of warrants to preferred and common stockholders had been justified for several reasons, mainly relating to the avoidance of formation of a new corporation (110, pp. 5-6). The Commission said, "we question the advisability of issuing securities without value, in view of the possibilities of transfer to persons less well advised" (110, p. 7). The warrants were to be exercisable for a period of two years at a price twice the existing market price of the stock. Obviously, such warrants would have little present value and were frowned upon by the S.E.C.

It appears that to some extent the S.E.C. may have misinterpreted the role which warrants might play in reorganization from the standpoint of achieving equity in the reorganization plan. Francis J. Calkins has asserted that the denial of the use of warrants or options by the Commission is unfortunate (24, pp. 27-28). The S.E.C. has relied on authorities who wrote only of management type options (24, p. 27). Calkins concluded that the only danger in options is the possibility that claimants would not know when or how to use them, if they should attain value. He said that these objections could be readily overcome by better dissemination of information regarding their terms

and expiration dates.

Graham, Dodd, and Cottle look with disfavor on stock purchase warrants due to overuse in new issues and the issuer's lack of control of additions to its capital in relation to the time of its needs (84, p. 661). However, the writers were in favor of the use of warrants in reorganization, stating that the question of the theoretical criteria should give way to equity and practicality. The authors were especially disposed to plans of railroad reorganization in which, by the finding of value for warrants, the proceeds would be used to pay junior creditors who would otherwise be forced to accept common stock reserved for them (84, p. 662).

Further treatment of warrants from their legal aspect will be made in Chapter VI of this dissertation.

Conclusions.- The S.E.C. has shown a willingness to approve highly stratified financial structures in a few cases, but shows no consistency in this regard. It should be recalled, however, that the S.E.C. does not prepare the financial plans. Possibly a different attitude on the part of the S.E.C. would mean more stratified plans would be offered. Such plans provide an opportunity for a larger total market value of securities. The S.E.C. appears to see the advantage of income bonds and preferred stock for this purpose, but approaches this matter in a conservative manner. Its objective appears to be to see that the creditors are paid off as rapidly as possible. This in itself may produce a lower present market value of securities due to the drain on earnings. On the other hand, the persistent efforts the S.E.C. has made to improve the quality of prior securities, in addition to providing greater compensation to creditors, may also have the advantage of

reducing the earnings coverage requirements below those required for nonreorganization securities. Reduction of earnings requirements may increase the potential quantity and variety of securities which might be authorized in reorganizations under Chapter X.

The Optimum Capital Structure

The purpose of this section is to present an approach to the development of an optimum capital structure for the corporation emerging from a Chapter X reorganization. It is posited that such a capital structure will result in the corporation having a maximum value both at the time of reorganization and in the future; and that by adopting such plans a greater participation of junior claimants can be allowed without violating the absolute priority rule. The optimum capital structure in reorganization may be defined as one which provides the largest quantity of claims in terms of present and future value. This value may result from both present and future claims on earnings, on assets, and on control of the corporation. This value may be realized through receipt of income or principal amounts from the corporation or by sale in the securities markets. Such a capital structure should contain the maximum quantity of senior securities consonant with the quantity of earnings available. This approach is consistent with general principles of finance. Graham and Dodd have stated that "optimum capitalization structure for any enterprise includes senior securities to the extent they may be safely issued and bought for investment" (129, p. 463).

The reorganization capital structure

Previously in this Chapter, suggestions were made to the effect that the reorganization capital structure may be different from the

capital structure of going concerns. Corporations being reorganized could start with a maximum of senior securities as recommended by Dan T. Smith for new closely held corporations (127, p. 155). Current earnings place the principal limitation on the quantity of prior securities. This approach may be consistent with the rapid debt reduction provided for in many Chapter X plans of reorganization. The ready acceptance by security holders of reorganization securities whose dividends are restricted and accumulated until debt is reduced or retired may further distinguish the reorganization capital structure. Lack of current earnings and dividends apparently do not importantly depress the price of common stock, if higher future earnings for these securities is a distinct likelihood.

The revised capital structure

The possibility of finding a substantially different valuation in some cases through the use of a revised capital structure is suggested by an approach used by Henry B. Gardner, Jr. (119, pp. 460-464). In this approach, Gardner applies the probable rates of interest to bonds and dividends to preferred stock which would permit these securities to "sell at par in a normal market" (119, p. 461). Gardner then demonstrates that the valuation found by this procedure is substantially higher than one found by applying an overall rate of capitalization to the same quantity of earnings.

In the hypothetical example used, Gardner showed that the new claim on assets could be highly disproportionate to the new claim on earnings, unless the overall rate of capitalization properly reflected the actual rates of capitalization derived from the cost of carrying the several segments of securities to be authorized. Assuming

$5,000,000 face value of 4 per cent bonds, $3,000,000 liquidating value of 6 per cent preferred stock, and 10,000,000 shares of $1 par value common stock at the time of default, prospective earnings of $900,000 capitalized at 10 per cent would produce a valuation of $9,000,000. If the corporation should retain the old priorities, the claim on assets of the old common stock would be $1,000,000, or one-ninth of the new valuation compared with one-half of the old valuation. However, common stock's claim on earnings would be $520,000, or almost 60 per cent of the new earnings. Such a result would raise a question as to the appropriateness of the overall rate and of its resultant valuation.

In applying separate rates of capitalization, the earnings applicable to common stock in the above example could be capitalized at a rate suitable for the risk related to common stock, say 15 per cent, to produce a valuation of $3,500,000 for this segment (119, p. 463). The total valuation becomes $12,500,000 instead of $9,000,000 found by the overall rate of capitalization. Gardner points out that this different valuation is equivalent to an overall rate of 8 per cent instead of the 10 per cent assumed for the overall method.

The S.E.C. has taken the position that the overall rate is in essence a composite of several distinct rates. In rejecting the "segmental method" offered by the trustee in the Childs Company case, the Commission stated that the "primary question involved is not the particular method, but rather the appropriate rate of capitalization which should be used" (4:24;111). The S.E.C. suggested that wherein the trustee had found different valuations by segmenting the earnings needed to service the debt and preferred stock, he could have reached identical valuations by applying a rate of 10 times earnings to the common stock

segment instead of 7 or 8 times earnings. The tendency of the S.E.C. to reject methods other than the capitalization of earnings at a single rate may be explained by its conservative attitude toward the total valuation.

On the other hand, Gardner points out that while similar valuations may result from both methods, there is less chance of error in "taking several small jumps, guided in each by reference to what appears to be a fitting financial structure and subject more or less to market check in fixing segment risk, than in taking one relatively unguided big jump" (119, p. 464). The merit of the varying rate technique "lies in the fact that it, as does the market, recognizes that different degrees of uncertainty attach to the realization of different segments of earnings" (119, p. 463).

In order to apply the method suggested by Gardner it is necessary that the absolute priority rule not be violated. Therefore, it is in order to briefly examine the implications of the method for the absolute priority rule.

Liquidation and investment valuation for creditors.- In order to comply with the absolute priority rule it is necessary that creditors be compensated according to the liquidation rights of the contracts. This requirement may be concluded to be equitable and necessary to avoid many difficulties which were encountered in equity receiverships. However, when substantial qualitative step-down is required, it appears to be unfair to junior interests to award senior interests with new junior securities representing claims on earnings and assets greater than their old claims, especially since they still retain the senior position with respect to assets and earnings. Throughout

its reports, the S.E.C. has stressed the liquidation rights of creditors. However, in the Green River Steel reorganization, it stated that "the cases do not provide a precise formulation of the standard by which fair treatment of the debenture holders is to be tested. There is a sound basis for saying that they are entitled to securities having an investment value equal to their old claim" (73, p. 21).

Under this dispensation it should be possible to fully compensate senior interests with new senior securities approximately equal in par values to their old securities and with new interest rates approximating the current market rates of interest. This should permit the reorganization securities to sell at par within a reasonable time after reorganization. When a step-down to common stock is required of the senior security holders, it should be possible to provide full compensation to them by the recognition of rights to some increased quantities of earnings, without regard to specific asset valuation. It should be pointed out, however, that senior interests seem to prefer to receive securities much like those they surrender and this fact should be kept in mind in deciding on the new capital structure. It is possible that in the case of senior securities, the absolute priority rule may be satisfied by their compensation with a quantity of securities whose claims on income would give them an asset value approximately equal to their old claims.

Market value for junior interests.- The recognition of liquidation values of old junior securities rather than their interest in the going concern value may be unfair to other junior interests, in some cases. Old preferred stock contracts may be quite strong as to their liquidation rights, but weak as to their value as a current

investment, without regard to the quantity of accumulations. However, when liquidation values, including accumulations, are measured against asset value made available by the capitalization of earnings at a single rate, the value of these claims are substantially increased. In order to comply with the absolute priority rule, preferred stock accumulations should be fully compensated, but the value of the compensation to these interests should be determined by attention to the market rates of dividends for comparable preferred stocks. The legal change required with respect to preferred stock contracts will be discussed in Chapter VI.

Residual value for common stock.- Under the absolute priority rule, old common stockholders, as the residual claimants, are not entitled to full compensation, except in the very unusual case where the value of the corporation in reorganization is sufficient to give such compensation. However, in every case it will be necessary to establish the valuation of the new common stock to determine the extent of participation by the junior interests. Under the method suggested by Gardner, once the appropriate quantities of new senior and middle rank of securities are determined, there is still a question of the appropriate quantity of new common stock.

Fergusson has described a method used in P.U.H.C. Act cases for determining the appropriateness of a distribution of securities between junior security holders (117, pp. 56-61). He states that the method, which is used regularly by the S.E.C. in administering simplification provisions of the P.U.H.C. Act, requires the application of a hypothesized rate of capitalization to the first layer of earnings available for preferred stock. If the computed rate of capitalization for the remaining earnings do not provide sufficient spread related to the risks

involved, the allocation of the residual securities would be too favorable to the junior claimants. This method was said, by Fergusson, to possess an advantage over the finding of the discounted present value of the expected earnings attributable to each of the two junior claims at two rates of discount selected independently by use of judgment alone (117, pp. 57-58).

Determination of the appropriate spread between the rate of capitalization applicable to preferred stock and to common stock is a highly subjective matter, even under the method described by Fergusson. Therefore, in testing the valuation results of two methods, it may be more appropriate to use a rule. Since earnings available for preferred stock are capitalized at the actual preferred dividend rate, earnings available for common stock should be capitalized at a much higher rate than the overall rate, due to prior charges having been deducted with consequent increase in risk of attainment of the last segment of earnings. Therefore, a rate approximately double the overall rate may be considered a conservative rule to apply.

A comparison of valuation results

A comparison will be made of the total valuation found by the S.E.C. in several cases of corporations with perpetual life assumed and of the same corporations valued by the method suggested by Gardner. Only plans of reorganization in which the capital structures were approved as to fairness and feasibility are used, since it would not be possible to make comparisons with indefinite results. The chart on page 219 presents data on the valuation of corporations, as made by the S.E.C., the amounts of the principal elements of valuation, the composition of claims against this valuation, and the capital structures which were actually approved by the S.E.C.

VALUATION DATA, CLAIMS AND NEW SECURITIES OF APPROVED REORGANIZATIONS, PERPETUAL LIFE ASSUMED
(All data in thousands of dollars, except rates of capitalization)

	S.E.C. estimate of earnings before Federal income taxes	S.E.C. rate of capitalization, per cent	Earning power valuation	Other elements of value	Total valuation	Total claims of creditors	Total claims of preferred stockholders	New Capital Structure		
								Debt	Preferred stock	Common stock
Minnesota and Ontario Paper Company*	$1,900	10.	$19,000	$ 6,584	$25,584	$55,000	$ 4,036[a]	$12,200	$ . . .	$13,384
The Higbee Company*	592	9.8	6,041	140	6,181	3,391	2,661	1,888[b]	1,386	2,757
McKesson & Robbins, Incorporated*	4,000	8.7	45,640	31,260	76,900	33,495	34,328	11,800[c]	5,900	43,405
Childs Company*	1,100	12.	9,166	1,134	10,300	1,600	7,845	1,600[d]	3,732	6,568

*Sources: (50) (69) (58) (65).

[a]Accumulated dividends not stated.

[b]Plus $150,000 cash distribution.

[c]Plus $15,795,486 cash distribution.

[d]Assumed mortgages.

Minnesota and Ontario Paper Company.- In the Minnesota and Ontario case, the S.E.C. recommended that, to be fair, the new income bonds should bear an interest rate of 5 per cent instead of the 4 per cent rate recommended by the trustee (50, p. 78). It is suggested that with a rate of interest of 4-1/2 per cent, at least $20,000,000 in new debt securities could have been authorized. The interest requirement would have been met over two times through earnings, in an industry of relatively stable sales and costs. After Federal corporate income taxes, there would have been a total of $620,000 in earnings available for preferred and common stock. These earnings would have supported at least $6,000,000 in 5.5 per cent preferred stock, leaving a balance of $290,000 in earnings available for common stock. If these earnings had been capitalized at the relatively high rate of 12-1/2 per cent after taxes, $2,320,000 in stated value of common stock could have been issued. The new total valuation would have been $34,904,000 or $9,320,000 more than the S.E.C. valuation. In this case, however, the revised valuation would still have been insufficient to have met the creditors' claims of $55,000,000. Yet, there is reason to believe that under the suggested revised plan, creditors would have been more fully compensated by the savings in corporate income taxes, by the higher stated liquidation value of securities, by higher claims on current income, and by higher probable market values of securities held.

The Higbee Company.- In the case of The Higbee Company, it is probable that all of the old debt claims could have been continued as new debt claims (69, p. 5). Certain claims of the holders of junior debt to the extent of $1,351,727.44, which were to be subordinated and converted into common stock, could have been converted instead into

subordinated notes at an interest rate of 4 per cent. Thus, the earnings requirement for the first segment would have been $136,000 for $3,400,000 in debt claims. Interest requirements would have been met over 4-1/2 times. Earnings available for preferred and common stock would appear to have been about $350,000, after deducting interest and estimated Federal income tax (69, p. 19). If a dividend rate of 5-1/2 per cent had been allowed for the first preferred stock instead of the 5 per cent rate allowed by the S.E.C., priority could have been maintained over new second preferred stock. The two old preferred stock claims could have been continued at a total dividend cost of $142,500. The remaining after-tax earnings of $207,500 could have been capitalized at a rate of 15 per cent or two times the 7.7 per cent overall rate of capitalization of after-tax earnings allowed by the S.E.C. This rate of capitalization would have produced a valuation of $1,383,333 for the common stock, which otherwise would have been eliminated. Total valuation by this method would have been $7,435,000 instead of the $6,041,000 valuation found by the S.E.C.

McKesson & Robbins, Incorporated.- In the McKesson & Robbins case, only 60 per cent of the valuation by the S.E.C. was calculated on an earning power basis (58, p. 17). Therefore, direct comparison of methods is not possible, since $15,795,486 was distributed in cash and additional securities were issued against assets with stated values of $15,465,000 for which no earnings were calculated or shown. However, it is clear that additional prior securities could have been issued.

After the cash distribution, a total of $17,700,000 in creditors' claims remained, which were converted into $11,800,000 in new debentures and $5,900,000 in preferred stock. If the entire $17,700,000

had been continued at a liberal 4-1/2 per cent, instead of the 4 per cent allowed by the S.E.C., only $796,500 of earnings would have been required for this claim. If one-half of the remaining income had been made available for new preferred stock, at least $20,000,000 in new preferred stock could have been made available against old claims of $34,327,904. It would have been possible to pay the old dividend rate of 6 per cent instead of the 5-1/2 per cent allowed by the S.E.C. and still have had earnings of $1,200,000 or more for new common stock. The old senior security holders should have been better satisfied and additional common stock could have been issued to the old common stockholders, who received only 19 per cent of the new common stock.

Childs Company.- In the case of Childs Company, $1,600,000 in mortgages were assumed, with annual interest requirements of $60,000 (65, p. 4). After-tax earnings of $676,000 would then have been available for preferred and common stock. Preferred claims totaled $7,846,000, including accumulated dividends. If $330,000, or approximately one-half of these earnings, had been made available for preferred stock, $6,000,000 in new 5-1/2 per cent preferred stock, instead of the $3,732,000 allowed, could have been issued. The remaining $346,000 of after-tax income could have been capitalized at 15 per cent to produce a valuation of $2,300,000 for the common stock. The total of these two layers of securities would have been $8,300,000. There were other assets, not necessary to the production of these earnings, which were valued by the Commission at $1,134,000. Accepting this valuation of these assets, the total value of the enterprise would have been $9,434,000, an amount $866,000 less than the $10,300,000 placed on the corporation by the S.E.C. It should be noted that the Commission's

valuation was higher than the $10,000,000 valuation made by the trustee (65, p. 4), and, further, that Childs was later unable to earn as much as the S.E.C. had estimated. This suggests that the segmented approach may have given a better estimate in this case as well as in the others where the Commission's estimates of earnings were lower than the level actually attained.

Conclusions.- Use of the method suggested by Gardner is highly dependent on the quantity of earnings and the market rates of interest and dividends at the time of reorganization. Redundant capital adds nothing directly to the earnings, but in many cases such capital may be liquidated and used to reduce the quantity of senior claims, thereby providing flexibility to increase the quantity of debt.

The method suggested by Gardner would yield a larger total valuation than the method used by the S.E.C. for valuation of earning assets, if the S.E.C. has recommended an insufficient quantity of prior securities or has utilized a rate of capitalization too high for the appropriate quantity of prior securities and the cost to the corporation of carrying such securities.

In many cases, even using this approach, no equity may be found for the old common stock. This is apt to be the case either when interest has accrued or preferred stock dividends have accumulated for a number of years. In such cases, it would be necessary to modify the rights of one or more senior securities in order to establish an equity for common stock, which would be in conflict with the absolute priority rule.

CHAPTER VI

CONCLUSIONS AND RECOMMENDATIONS

The purpose of this chapter is to present the main conclusions reached as a result of the research and to make recommendations for changes in methodology and procedures and for changes in laws related to corporate reorganization under Chapter X of the National Bankruptcy Act. The suggested changes are those which may lead to more equitable treatment of security holders of failed corporations. The factors which contribute to inequities will be introduced at the appropriate points.

Principal Conclusions

Under the common law relating to debtor and creditor relationships when a creditor purchases credit instruments he bargains for certain rights. When assets of a debtor are turned over to the courts, securities contracts become matured as to their liquidation rights under the common law, and in equity receivership in the absence of an express agreement waiving such rights. The interpretation of contracts may be spelled out in statutes and may be modified by precedent case law. Under Chapter X, the intent that contractual rights be observed is clearly expressed in those sections relating to insolvency and the right to participate in the reorganization. Since reorganization under this statute is a substitute for liquidation, payment may be made in cash or securities up to the extent that value is available. Payment must be made in full and in the order of legal priority under the absolute

priority doctrine which governs Chapter X reorganization. This fact was fully affirmed in the landmark precedent cases.

The accuracy of the valuation

In order to apply the absolute priority rule under Chapter X, a valuation of the corporate assets must be made. The Court said, in the Consolidated Rock Products case, that it is not possible to reach an earning power valuation with "mathematical certitude" (3, p. 685). However, the S.E.C. approaches the valuation of corporations undergoing reorganization in a methodical and authoritative manner. In Chapter III and Chapter V, it was concluded that the methods the S.E.C. uses fall short of providing the best valuations under the circumstances. Certain improvements in techniques were suggested in those chapters.

Development of a complete model for forecasting the future value of a corporation awaits further research and is entirely outside the scope of this dissertation. However, some research has been conducted in this field. Myron J. Gordon has constructed models designed to predict the value of shares in corporations based on four variables, the current income, the rate of retention of earnings, the rate of return on investment, and the rate of profit required by investors (82). The models take into account optimal internal investment decisions, financial structure, taxation, and allowance for risk, among other variables. Empirical tests are made of the models (82, chaps. 12-15). The variations in the assumptions made by different investigators in this field point up the need to validate such models as they are developed theoretically. The present rapid development of high capacity, high speed computers makes this possible. It is suggested that the S.E.C. should give recognition to developments of this nature in its valuations.

As a result of the findings of Chapters II, III, and IV, it appears that little attention is given to the management factor in valuation of industrial assets. Old management guilty of mismanagement or fraud may be eliminated, but no means is deliberately made available to encourage the return of an old management which was beset by the vagaries of the business cycle. Harry G. Guthmann, among other writers, concludes that the same earning assets in the hands of the old management will give the reorganized corporation a higher value than in the hands of a new management receiving similar salaries (63, p. 743). Since the old management may lack alternative opportunities, they might undertake the management of the reorganized company at very reasonable salaries.

Dewing points out that a going concern is dependent on three elements of value, its fixed assets, its current assets, and a "group of intangible values" (40, p. 282). Among the more important of the intangibles is the organization or the human element which distinguishes a going concern from a dead business (40, pp. 283-286). This suggests that an insolvent corporation could be temporarily depressed in value due to the change in management.

During low stages of the business cycle, market rates of capitalization may be higher than normal and may influence the selection by the S.E.C. of the rates of capitalization or discount to be applied to the earnings of corporations being reorganized. The securities of companies being reorganized are likely to be depressed in price both prior to and following reorganization. The exchange of old securities at their liquidation values for new securities at their presently depressed going concern values makes it possible to overaward senior security

holders. Under low valuations, some classes of security holders will be eliminated or undercompensated, thereby overawarding other classes of security holders.

The valuations made by the S.E.C. may be deliberately conservative in order to assure that the absolute priority rule is observed as to the senior interests, who are entitled to nothing less than full compensation under the law. In many cases, according to early studies, senior security holders were overawarded by the test of market value of securities received after several years. The total market value of securities outstanding after several years, also exceeded the S.E.C.'s total valuation, according to early studies. These tests, also, showed overvaluation in a few cases.

In addition, flagrant undervaluations at the time of reorganization were made in at least two cases, the Deep Rock Oil Corporation (48), and the Flour Mills of America (60), in which the S.E.C. was subsequently overruled by the courts. In later cases, the courts appear quite likely to accept a valuation near those advised by the S.E.C.

There is some evidence, according to Billyou, that security holders are willing to accept "dubious plans," rather than go to the expense of an appeal (23, pp. 486-487). Willingness of both creditors and equity interests to accept approved valuations may be based, in part, on the apparent authoritativeness of the findings. With regard to valuation, appelants must prove either that a defective method was used or that material facts bearing on valuation were not disclosed.

As a legal and practical matter, the S.E.C. is on safe ground when it says that valuation only at the time of reorganization need be predicted and that only reasonably foreseeable changes need be

anticipated. The date of the final decree is the cutoff date for seeking modifications in a plan of reorganization and the various interests may be at a disadvantage in appealing a decision on a plan made after considerable negotiation and deliberation.

The fair and equitable distribution of securities

In the Consolidated Rock Products case, it was established that "full compensatory provision must be made for the entire bundle of rights which the creditors surrender" (3, p. 686). Unless the creditors are paid in cash in accordance with their liquidation preferences, they must be awarded new securities with par or stated values equal to the old securities, plus approximately equal claims on income. In a sense, this is better treatment than one might ordinarily expect, since income usually ceases upon liquidation.

The statutes, also, require that plans of reorganization be feasible. The main requirement of feasibility is that the emergent plan of reorganization contain no features which may create additional financial strains in the foreseeable future. Feasibility standards of the S.E.C., while somewhat uncertain, result in generally conservative capital structures. When such structures are associated with conservative valuations, new securities similar to those surrendered by senior interests are relatively small in amount. This means that holders of senior securities must accept some securities of lesser quality, while not relinquishing their priority position. Loss of some qualitative feature must be compensated quantitatively. This means that qualitative step-down places a progressively larger strain on the limited quantity of new securities. Since the quantitative step-up is usually

generous in relation to the conservative valuation, there is seldom any value left for the most junior classes of securities.

Equitable treatment of junior interests is not a requirement of a fair plan until senior interests have been fully satisfied as to their legal and contractual rights. Under the absolute priority rule, junior creditors and preferred stockholders participate to the full extent of their liquidation rights in the free assets. With a few exceptions, the plans of reorganization were fair, by these criteria, to all participating classes. However, in almost all cases, the interests of one or more classes were eliminated by the valuation. In a few cases, the valuation was precisely equal to the claims of the participating classes.

The most serious distortions of compensation between classes occur in perfectly horizontal plans of reorganization, since under such plans the value of all claims varies proportionately with the market value of the common stock after reorganization. Hierarchical plans of reorganization offer the greatest opportunity to preserve the previous order of priority. The distribution of value with respect to the old securities of corporations with complicated capital structures, or of holding company systems, requires very delicate balancing of rights under which precisely fair treatment may not be achieved, e.g., the several plans of the trustee and the S.E.C. in the Inland Gas case (4: 30;60).

However, the simpler capital structures normally encountered in industrial reorganizations do not pose the same problems as corporations with complex capital structures. In the former cases, the new capital structures may appear to be much like the old except as to the total

capitalization and by whom it is held. New plans which contain a full dress hierarchy of new securities have a much better chance of preserving priorities in case of subsequent liquidation, but they also provide the opportunity to preserve claims on the value of the going concern. Since holders of new prior securities lose much less than if they held a portion of the common stock, they may be much more prone to accept such provisions for them in the plan of reorganization without making excessive quantitative demands.

On first blush, a solution to the problem of equitable treatment using this approach will suggest the relative income priority rule. However, it should be recalled that this latter approach to reorganization was not based on liquidation values, but rather on present investment values. Extravagant income projections for the securities issued was the main defect in the equity receiverships, although this is not mentioned nearly as often as other shortcomings. Identification of relative income priority with hierarchical capital structures is an incorrect attitude, since the vertical plan is encountered often under absolute priority systems of reorganization, including Chapter X real estate reorganizations.

Theories of compensation

The precedent cases have importantly affected the interpretation of the statutory requirements of compensatory treatment in reorganization. Within a relatively short period, from 1939 to 1945, the precedent cases established that different considerations will govern the application of the absolute priority rule in the three most comprehensive reorganization settings. Henceforth, somewhat different standards governed the rights which were to be recognized and the method of

compensation under Chapter X, Section 77, and the Public Utility Holding Company Act.

Under Section 77, the I.C.C., with more leeway to control the emergent plan than the S.E.C. under Chapter X, has paid attention to rights other than contract and liquidation rights. Feasibility rather than strict attention to immediate fairness to senior interests has tended to govern the railroad counterpart to Chapter X reorganizations. The I.C.C. evolves plans of reorganization with attention to maximum permissible capitalizations which may be supported by expected earnings of the railroads. The public policy objective of keeping the railroads in operation has apparently caused the I.C.C. to attempt to find a place in the new capitalization for as many of the old security holders as practical. As with the relative priority theory, it is hoped that the corporation will grow in value and that the full liquidation values of the old securities may be realized either through the sale of the new securities in the market place or through redemption by the corporation. The method is said to attempt to maximize the present value as well as the future value of the new securities by issuance of a full dress hierarchy of new securities to include some contingent income securities. It is said also to attempt to maximize the amount of securities of each class by strengthening these as to protective features and by attention to the minimum earnings requirements and asset coverage. The approach has been termed expansible value.

As a practical matter, it is usually only the highly layered structure of old main line and divisional liens which share in the reorganization. Still, the approach appears to provide more present value for the same quantity of earnings than that used by the S.E.C. By the

direct exchange of securities without a dollar valuation of the property, it uses a limited investment value approach, at least as to the junior securities.

The investment value standard rather than liquidation standard tends to dominate most statutory reorganization settings. Strangely, however, the same general line of cases govern all reorganization settings. The main distinctions are to be found in those cases which deal with the intent of Congress as to the meaning of the statutes. Even similarity in the language of the statute does not preclude a different interpretation. For example, "fairness and equity" is the standard of the Public Utility Holding Company Act, as well as of Chapter X and of Section 77.

In the early period, the absolute priority rule of full compensation dominated P.U.H.C. simplifications. In the Otis case, the Supreme Court ruled that the absolute priority rule embodied in the fair and equitable standard must be modified in simplification cases (44, pp. 633-636). The P.U.H.C. Act was a Federal law and Congress did not intend that the operation of the law would bring about the maturation of contractual rights. Therefore, the provisions of a state granted charter would not govern the claims to be measured and compensated.

The principal security which is affected by the investment value standard is preferred stock. The decision as to whether liquidation value or investment value (which normally would be the lower of the two) will govern the measurement of the claims of preferred stock is the principal distinction between Chapter X and most other reorganization statutes. However, the principle may not be well settled. In Chapter

X cases, it appears that "denials of certiorari have barred a square Supreme Court ruling on the point" of whether liquidation claims are the principal standard for measuring the amount of entitlement of preferred stock to participation (116, p. 662).

Neither the expansible value approach nor the investment value approach has any great implications for Chapter X reorganization under the present law and administrative and legal philosophies, but it seems likely that the incorporation of these approaches in the administration of Chapter X would provide greater fairness and equity without conflicting with the basic philosophy of absolute priority.

Suggested Changes in Methodology and Procedures

Changes in methodology

The changes in methodology to be suggested here concern both the valuation of the corporation and the distribution of securities. By these suggestions it is believed that it is possible to reconcile the absolute priority rule with a more accurate valuation, and consequently, a more equitable distribution of securities. The changes involve two sets of considerations; namely, first, those rights which will be recognized in reorganization, and second, the kinds and amounts of securities with which they are to be compensated.

The first step is to recognize the full liquidation rights as to both principal and income of old debt securities. This procedure will square with the absolute priority rule as to creditors' rights. The next step is to recognize the rights of senior equity holders to their full claims on future income at least equal to their present

claims on income, whether fixed or contingent. This procedure will require some legal modification which will be discussed under the proper heading. The third step is to recognize the rights of common stockholders as claimants to residual income rather than to a specific asset value.

In considering the kinds and amounts of compensation, the first step is to authorize the maximum amount of fixed interest debt that may be justified by the stability and quantity of earnings. This amount may be determined by the minimum and the average before-tax earnings estimated for all future years. In a direct approach to the problem, the appropriate debt might be based on the quantity of earnings available from the lesser of one-half of the estimated average earnings or four-fifths of the estimated minimum earnings. When this amount has been determined, it may be divided by the coupon or market rate of interest to determine the maximum amount of debt which might be authorized in these situations. Earnings coverage requirements may be varied from this makeshift standard when suitable standards are developed.

It is questioned whether reorganization securities need meet the asset coverage requirement expected of successful companies. The purpose of asset coverage standards is to assure that sufficient asset value remains to pay debt holders in case of downward appraisal of the assets upon failure, but this purpose is accomplished by the process of valuation in corporate reorganization. Even if both asset coverage and earnings coverage should be considered together, "the capital issues of the new corporation need not meet the conservative standards of new issues that have to be sold" (63, p. 749). If the earnings only requirement is used it will permit more liberal issues of fixed obligation

debt and preferred stock than is presently advised by the S.E.C.

The next step is to authorize contingent income securities to the fullest extent that probable income exists for them. Such securities should be strengthened in every way possible to prevent their selling at depressed prices after reorganization. Whenever possible, the contingent income securities should be income bonds, rather than preferred stock, because of the tax savings related to interest on debt. It is possible that holders of old junior debt might prefer a weak junior bond over a much larger nominal quantity of common stock in the new company. The addition of the convertible feature would make possible even greater value for distribution to junior interests, and would have the added advantage of providing an option to purchase new common stock in the event of undervaluation. Provision in the plans for sinking fund payments varying with earnings should relieve some of the strain on earnings coverage requirements.

The existence of liberal quantities of income bonds and preferred stock in the new capital structure may be offset by heavy earnings retentions, which may be used to retire debt or to make capital expenditures. The Commission follows this procedure in some cases, but usually allows only limited discretion to the new common stockholders as to whether to use retained earnings to simplify the capital structure or to expand the operations. Such restrictions may dampen investor interest in the new corporation.

If the above approach were adopted, in many reorganizations, intermediate securities would be issued to the junior creditors, whose new liquidation rights would be considerably reduced, even though rights to income should be greater. Despite this approach, in many cases, old

junior creditors and preferred stockholders would receive new common stock for all or part of their claim. The claim on income at this level should be somewhat proportionate to the interest. Let us say that the old junior creditors have an unsatisfied claim on earnings, at this point, of $10,000 per year and that $20,000 in earnings are available for all remaining claims. The class of security holder, already partly compensated with prior securities, should receive half of the new common stock. Priority for the old securities is maintained through the new prior security received. Only when an old prior security must share equally with a lower rank of old security will its proportionate share be stepped up. When this occurs, and possibly in other situations, one additional security in the form of a warrant to purchase common stock should be issued in order to maintain complete priority of position.

This general approach to valuation will not become a relative income priority position if sufficient asset value is present to equal all old creditor claims to assets, and possibly old preferred stock claims to assets as well. A valuation of the corporation will have to be made.

Several approaches to the problem of earning power valuation exist aside from a simple capitalization of estimated earnings at a single rate of capitalization. In one approach, no rate of capitalization is applied directly to the interest deduction. Interest is charged as an expense and only earnings after interest are capitalized. Another approach would be to apply the actual interest rate to that portion of earnings available to pay interest and to apply another rate to the remainder of the earnings after taxes. A third approach would be to apply a rate allowing a margin of safety to the portion of earnings available

for debt and to apply another rate to the remainder of earnings. A fourth approach is to apply the probable or actual interest or dividend rates to the earnings required to permit each security in the capital structure prior to the common stock to sell at par in a normal market or to be clearly acceptable to security holders. The remaining available earnings may then be capitalized at a rate appropriate for common stock to determine the amount of that security which may be authorized.

The optimum financial plan

The optimum financial plan is one which minimizes the average cost of capital. The last, or fourth, method mentioned above is most appropriate for that purpose. But, the capital structure should also contain the largest possible variety of securities. A larger variety and quantity of securities, especially junior securities, in the capital structure will usually produce a higher total market value of securities. In the procedures just outlined, the maximization of market value of all securities in the capital structure, including the full liquidation preferences of new senior debt securities, will minimize the cost of capital to the corporation. The cost of capital should be taken into consideration in reorganization to assure equitable treatment to all security holders.

Highly variable debt to equity ratios emerged in reorganization under Chapter X. Low or conservative valuations tend to place an absolute limit on the quantity of debt, thereby forcing too much compensation into the form of junior securities. Debt is particularly advantageous to a corporation because of the savings in Federal corporate income taxes. Failure to take full advantage of the tax deductible nature of debt is a disservice to senior interests, as well as to junior

interests, since it places an additional and unnecessary cost burden on the corporation.

The application of earnings method just outlined may not yield a different valuation than that found by the S.E.C. by the usual method of applying a single overall rate of capitalization to the earnings for the given corporation. However, the test may be used to determine whether the maximum amount of debt and other prior securities have been included in the plan by the S.E.C. The application of very high or very low rates of capitalization to junior securities, after the actual interest is deducted, would indicate possible undervaluation or overvaluation by the S.E.C.

The S.E.C. has paid little favorable attention to the speculative value of new securities. Market value of securities has some meaning under Chapter X, although it is not the test of full compensation if the market values lie below the liquidation values on which basis the exchange of securities takes place. Under the optimum capital structure, holders of old securities would be fully compensated with new securities whose liquidation values exhaust a large part of available earnings, but the value of additional junior securities will be based more on market values than on present liquidation values. Such securities should be issued to the extent they are not misleading to present or future security holders or that they are worthless, on any basis, at the time of issue.

Suggested Changes in Laws

In order to accomplish more equitable reorganizations, two changes in the law are recommended. First, it is recommended that legal

recognition be given to the use of warrants in reorganization. Second, it is recommended that the claims of preferred stockholders be recognized as to the investment value of their claims rather than as to the liquidation value of their claims. These changes may be made without changes in the statutes, since the procedures related to both are based on interpretation of the intent of Congress.

Stock purchase warrants

The S.E.C.'s refusal to approve the authorization of stock purchase warrants is possibly due to its desire that the reorganization valuation be made final at the time of reorganization. However, in order to allow for the possibility of error in the valuation, such warrants could be awarded in industrial reorganizations for limited periods of five or ten years, to the class which is barred from participation by a small margin, all prior classes having been fully compensated, except the class next senior. Each of the two classes could receive some proportion of warrants, possibly at different prices. The more senior group could receive warrants exercisable slightly above the then existing value of the common shares, so there would be no immediate dilution effect. The junior group could receive warrants exercisable at a price sufficiently above the reorganization values so that the dilution effect would be minimal. The exercise price of the junior warrants could be scaled upward in steps over time so that only in cases of unusual appreciation in value of common stock would they be entitled to share in the new prosperity of the company.

The S.E.C.'s principal objections to warrants are to be found in the case of the Childs Company (4:24;120-122). It was stated that long term warrants are "unsound from the standpoint of the company.

They are not likely to be exercised at a time when the company has an urgent need for capital, but when the company needs it least" (4:24; 121). Second, long-term warrants were said to be objectionable from the standpoint of the public due to their wide market fluctuations. Third, it was said their use may conflict with Section 216(12)(b) of Chapter X, which spells out the requirements against the issuance of vague or misleading securities. Fourth, it was said their use may conflict with Section 216(12)(a) of Chapter X, which prohibits the issuance of nonvoting stock. The S.E.C. asserted that warrants are in effect a junior equity security without voting power. Fifth, the S.E.C. pointed out that the New York Stock Exchange has refused to admit long-term warrants to trading.

The above objections to the use of warrants are not so serious as may first appear. It must be recalled that a cloud lay over warrants for many years due to the widespread use of free stock options by market manipulators in the 1920's, and there has been some tendency to confuse the two. The first objection probably has the greatest validity; however, experience has shown that most warrants are not exercised, but rather are traded, whether they would yield a profit by being exercised or not, unless their exercise occurs shortly prior to expiration of the right. Actually, all warrants, except listed and a few nonlisted warrants of great popularity, carry a wide spread between the bid and asked prices.

The second objection is not too serious. While it is true that the percentage fluctuation in the prices of warrants is greater than the common stock on which based (because the warrants are lower in price), the absolute difference in prices of warrants is not very

great, corresponding very closely at most times.

The third objection has little relevance since most people could be presumed to know the nature of the warrant which they were given in lieu of receiving nothing, and the warrants could be made nontransferable.

The fourth objection is hardly valid, since the warrant is merely a right to purchase the stock; it constitutes no equity in the corporation, but, if exercised, voting stock would then be issued. In this regard, it is as harmless as a convertible security, for which unissued voting stock is authorized.

The fifth objection is not consistent, since the American Stock Exchange, being a lower priced market, lists some warrants in important companies, in which some trading may be expected. It is noteworthy that approximately 20 per cent of all new common stock issues involve the granting of warrants to underwriters as partial compensation. Since these underwriters must include many of the member firms of the New York Stock Exchange, apparently these firms are willing to carry them in their own portfolios, and, in fact, some of them make a market in warrants.

It appears that the failure of the courts to approve warrants in Chapter X reorganizations in recent years may be due to the interpretations of the S.E.C. in its advisory reports. If so, no change in the law is necessary. However, the legal status of warrants could possibly be tested in the courts. It appears that legally warrants are equivalent to the convertible feature of bonds and preferred stock. In some respects, warrants appear to be equivalent to junior common stock.

Preferred stock

It is suggested that under the laws of reorganization preferred

stock should be treated as a senior equity security rather than as a creditor instrument. Liquidation rights of preferred stock are often as much as 110 per cent of the principal amounts, plus their accumulated dividends. While stated liquidation rights of preferred stock should probably govern in bankruptcy, there is no apparent reason why they should do so in reorganization. The decision to recognize the full liquidation value of preferred stock in Chapter X cases was accomplished some twelve years after Chapter X was enacted, in the case of Central States Electric Corporation v. Austrian (94).

Failure of the courts to recognize this distinction between creditors and debtors should be corrected by statute, if necessary, to secure more equitable treatment to holders of securities which are junior to preferred stock. However, it is possible that the courts could recognize the investment features rather than the liquidation rights of preferred stock and still comply with the absolute priority rule as established under the fair and equitable standard.

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BIOGRAPHICAL SKETCH

Charles Benjamin Franklin, Jr. was born in Jacksonville, Florida, on March 17, 1917. He moved with his family, at the age of 8, to Fort Myers, Florida, where he attended public school and was graduated from Fort Myers High School in 1935. In 1939, he received the degree of Bachelor of Science in Business Administration from the University of Florida. After graduation, he was employed as a field man for General Morots Acceptance Corporation and in 1941 left this employment to enter the United States Army. He served throughout the war years (2 years of which were spent overseas) in the Army Counter Intelligence Corps. In 1945, he was honorably discharged, having attained the grade of Technical Sergeant. Upon discharge from the army, he returned to Fort Myers where he was employed as Veterans' Service Officer for Lee County.

In March, 1949, he was called to active duty with the Army and served in the Counter Intelligence Corps during the Korean War. He was discharged in 1953 with the rank of First Lieutenant. Upon discharge, he entered the graduate program in the College of Arts and Sciences at Florida State University. In January, 1956, he was awarded the Master of Science degree with major in economics, following which he entered the Ph.D program in the College of Business Administration at the University of Florida. He completed residence requirements in 1958. He was employed as an Instructor in the Department of Economics, Florida

State University from September, 1958, through May, 1960. In June, 1960, he accepted an Assistant Professorship in Business Administration at Auburn University, Auburn, Alabama, and continued in that position until August, 1963. He returned to the University of Florida in September, 1963, as an Interim Assistant Professor under a one-year appointment. In July, 1964, he joined the faculty of Florida Atlantic University, Boca Raton, Florida, as an Assistant Professor of Finance, in the College of Business Administration.

He has been married for 18 years to the former Carlotta Morriss Sanders of Chilhowie, Virginia, and they have two sons - Robert Stephen, and Timothy Alan. He is a member of the Southern Economic Association, the Southern Finance Association, Alpha Kappa Psi (business fraternity), and Theta Chi (social fraternity).

This dissertation was prepared under the direction of the chairman of the candidate's supervisory committee and has been approved by all members of that committee. It was submitted to the Dean of the College of Business Administration and to the Graduate Council, and was approved as partial fulfillment of the requirements for the degree of Doctor of Philosophy.

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